Fundamentals

OF

ECONOMICS

By

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PART VII

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CHAPTER XXXIX

MONEY

The origin of money. The use of money seems to have resulted from the inconveniences which were experienced in barter exchange, more particularly when society advanced to a complex living. For then every man could not make all the articles of his choice so that others had to be found who could give him such articles as he did not possess himself in exchange for his own. The chief handicap in barter economy lies in the difficulty with which men are available who are willing to exchange their articles with the articles of other men. That is due to the lack of coincidence of their respective wants. If some men want milk and butter in exchange for their caps and shoes those who can provide them with these articles might not be wanting caps and shoes. And in such a situation exchange cannot take place unless prople are available who want caps and shoes in exchange for milk and butter. But the difficulties are not over in the mere availability of such men. Those making the exchanges would have to find out the values of milk and butter in terms of caps and shoes jointly and separately. And further when caps and shoes are later exchanged for a variety of other articles a valuation of their separate prices in terms of these articles has again to be done. The price of a cap would be expressed in no single measure of value but in a variety of things which might range from cabbage to the crown. As with this cap, so with every other article with which this cap might exchange itself in society. Nor is the difficulty over when evaluation in terms of hundreds of other articles has been done somehow. If one cap is to exchange for one seer of milk, how many will exchange for a seer and a half ? Surely if the cap is cut into two, it becomes no better than a cloth duster and might not be wanted any more. And if this cutting is not done, either more milk must be parted with so that two caps might reach the milkman or one cap must be parted with so that a full round seer of milk might reach the cap seller. This implies that either the milk seller must demand more caps than he would have originally wanted or the cap seller must demand more milk than he needs to consume.

Barter thus leads to the inconveniences, first of finding men who mutually demand each other's articles and then of

evaluating the price of each good sold by men, in terms of all such articles as the seller of the good in question might want in exchange and lastly of sub-dividing the articles of exchange in case such a need arises

Money has helped men rid themselves of these inconveniences And consequently its use has become widespread and in the particular setup of the modern world economy, almost indispensable

Definition of money Let us define money and see what specific functions it discharges in human society Money has been variously defined by various authors We will not spend time in analysing the various definitions and then finding for ourselves the correct one We will rather accept as correct a definition that is widely accepted by economists Such a definition is Prof Robertson's "Money, he says, denotes any thing which is widely accepted in payment for goods or in discharge of other kinds of business obligations" The chief characteristic of money is its wide acceptability As puts it If things which are intended to be money—the notes of certain Governments for instance cease to be widely accepted in discharge of obligations, they cease to function as money and to be money On the other hand, if things which have not been hitherto considered as money such as tobacco or cattle or tins of bully beef, become widely accepted in discharge of obligations, they become money"

Functions of money But for a thing to be widely acceptable, it is necessary that it should be expressible in terms of a measure or standard of value of things in general A cheque is a widely acceptable thing because it can be expressed in this country in terms of rupees, annas and pies which help us to measure the value of all the goods produced and exchanged for purposes of consumption Cheques in India would cease to be widely acceptable if they were not to represent rupees For, then they would cease to express a common measure of value Men accept cheques because they know that after their encashment, they can easily purchase any article they need for their satisfaction Like this cheque, then, nothing would be generally accepted unless it was capable of being expressed in terms of a common measure of value Money thus is something which is expressible in terms of a common measure or a standard of value for then alone can it be widely acceptable

It is the quality of money that it represents a command over goods in general which makes it perform the functions

commonly assigned to it. Money, they say, is a medium of exchange and facilitates the buying and selling of goods and services. Whether it be a cap seller or a seller of milk, he will be able to satisfy his demands with the money he gets from the sale of his goods without having to bother about finding people who need his goods in exchange for their own. A cap seller who wants milk will sell his caps for money and then purchase milk with that money. The milk seller might or might not need caps, but he will always accept money in exchange for milk knowing that he can at any time exchange it for whatever he wants. Money thus brings about exchange even between parties that do not need each other's goods.

Being a unit of account i.e. something in terms of which the value of all goods can be accounted or evaluated it naturally helps us to fix our choices of goods and the various amounts of them without the least difficulty. And so it facilitates the achievement of maximum satisfaction which is the economic end of all human behaviour.

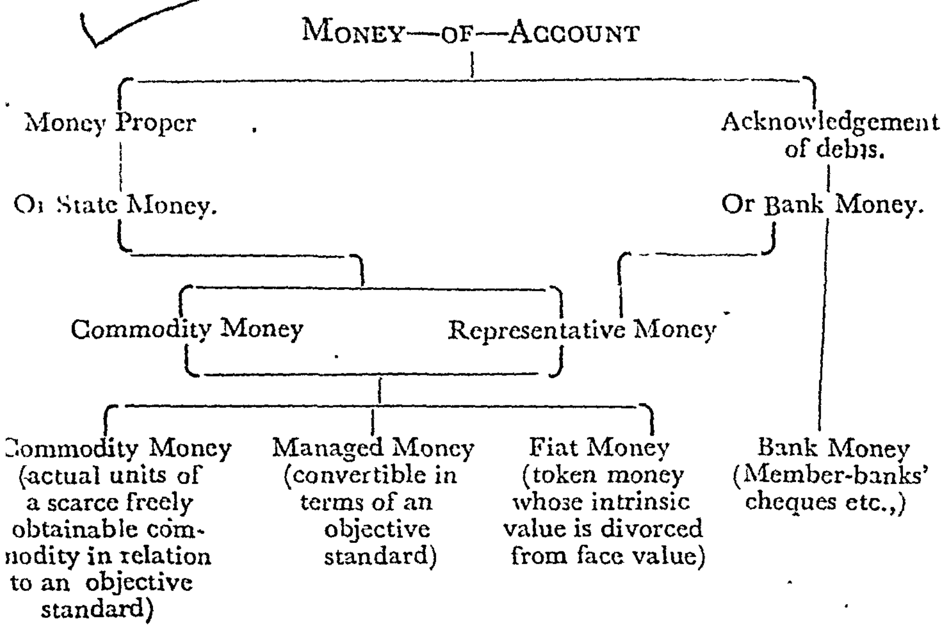
A further function of money consists in its being what they call, a standard of deferred payments. When prompt payments are made, money, we can see, serves as a standard for such payments. When payments are to be made after sometime as when a loan is returned or commodities paid for months after they are purchased, values are again reckoned or expressed in terms of money. What is important here to note is the fact that a unit of money—a rupee, say, for example—which serves as a standard for prompt present payments serves also as a standard for future payments considered as possessing the same purchasing power as it has in the present. Present contracts involving future payments do not take as standard the future purchasing power of money. If a hundred rupees' debt contracted today is to be paid back after a year then only hundred rupees would be paid back after that time despite the rupee having become weaker in its purchasing power. If one has contracted to receive fifty articles after a year at the average rate of five rupees an article, which happens to be the rate today, one must pay two hundred and fifty rupees to his seller even if the articles in question are being sold at four rupees an article at the time of payment.

The next function of money is to serve as a convenient store of value. We have seen above that money being a common measure or standard of value has the power of commanding other goods in exchange for itself. And so when people store

by the name of money does correspond to the description of the money of account.

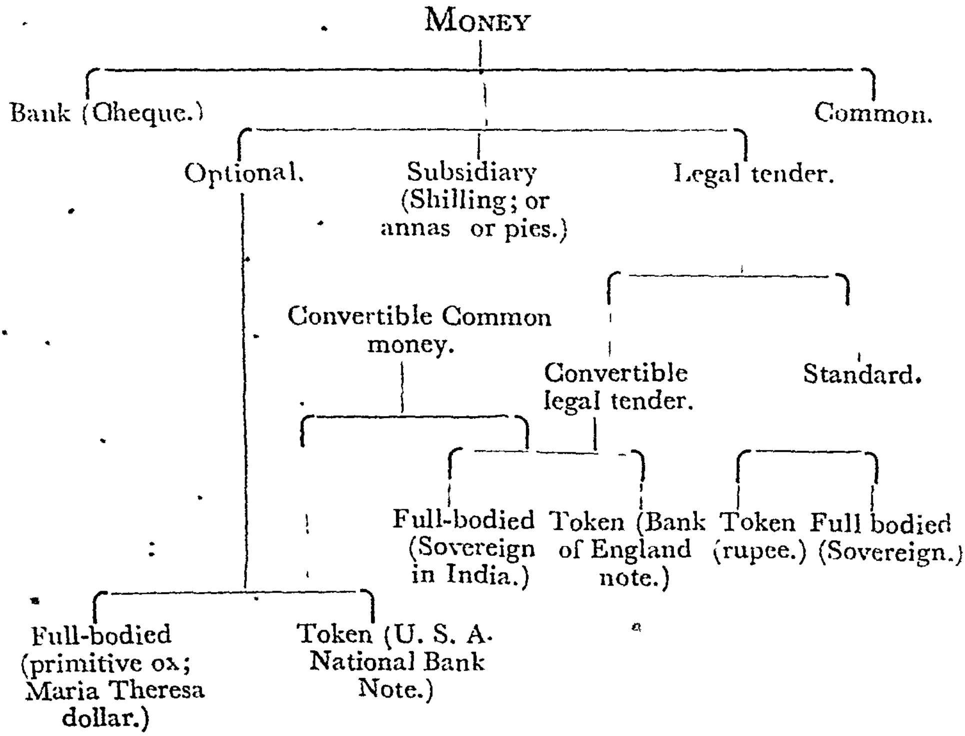
Money is now classified into two chief varieties: one is what he calls money-proper and the other bank-money. "Bank-money" he says, "is simply an acknowledgement of a private debt, expressed in the money of account (a cheque expressing demand of say hundred rupees from a bank) which is used by passing from one hand to another, alternatively with money-proper, to settle a transaction". Money-proper is the money issued by the State and hence is also called State-money. In State-money Keynes includes not only compulsory legal tender but Bank Notes and Central Bank Deposits also. Bank-money is mainly composed of member bank deposits.

The following is the chart of his classification :—



Thus we are eventually left with four varieties of money with which to do our exchange transactions. Three of these varieties viz. commodity money, managed money and fiat money belong to the class of money-proper and one viz. Bank-money belongs to the Acknowledgement of Debts. The total amount of current money held by the public comprises all these varieties.

Put in a tabulated form, Robertson's classification is as follows :—



Prof. Robertson's classification is preferable to Keynes's for the varieties in his classification are not overlapping. A five rupee note, for example, would only be put in the variety of common convertible token legal tender money and in no other, though there are five other varieties alongside. In Keynes's classification, it can be put into two classes at the same time. It may belong to the "fiat money" class or the managed money class. If money is to be properly classified, the classification should be such that no single variety of money should appear as belonging to more than one class at a time. Or else we would say that the classes are over-lapping, the same thing being put in one and then another class at the same time.

Prof. Robertson's classification, moreover, is very elaborate. Keynes recognises four varieties of money, whereas Robertson recognises seven. And we know what elaboration in classification leads us to. It makes possible a more thorough and scientific grading of classes and hence minimises the chance of the classes overlapping amongst themselves.

CHAPTER XXXX

VALUE OF MONEY

We now address ourselves to a problem which has become perhaps the only topic of discussion in the midst of monetary theorists for some time past. This is the familiar problem of the value of money, the technique of its measurement and its vital place in modern economy.

Significance of the functions of money—From looking at the functions which money is said to perform in a society, one might be tempted to conclude that money is unimportant for it is only a convenient tool for making exchanges and incurring debts. If this tool were not to be there, exchanges and debts would not cease to be made; they would continue to be made as in the past though only with difficulties. And so money has no independent identity to be capable of exerting some influence of importance on the working of men's economy. The classical economists took this view of the matter and that is why to them the problem of the value of money did not assume any vital importance. But to the monetary theorists of today who have witnessed the wide fluctuations in the economic conditions of the people as a result of changes in the value of money, the problem is no more of a trivial importance. Money to them is much more than a mere tool used for the convenience of the people—it is something of which men themselves seem to be becoming a tool with the advance of time. In such a situation, the view expressed by J. S. Mill that "there cannot be intrinsically a more insignificant thing, in the economy of society, than money" is wholly unacceptable.

If money could perform its functions smoothly in the economy of a society we would have called it "insignificant"; we would have considered it as of no more or no less importance than is given to any technique or tool that saves the labour of man. But that unfortunately is not the case. When money gets out of order it exerts a vital and sometimes a terrible influence on the working of men's economy. Mill recognises this fact when he says "Like other types of machinery it (money) only exerts a distinct and independent influence of its own when it gets out of order." But Mill was not conscious of any frequent and terrible disorders in the machine to call it significant.

The significance of money emerges from the fact that it functions with great leaps in its value, or which is the same thing its purchasing power is seldom constant The reasons why this happens will be seen in the theory of the value of money which we will take up in a subsequent chapter Meanwhile we digress a bit to find out how this inconstancy in the purchasing power of money or the value of money is measured But even before that let us examine the meaning of the phrase value of money

Meaning of value of money'—When we speak of the value of a pen we mean that it will command for the pen-seller an amount say, of a couple of rupees in such and such a market at such and such a time When we speak of the value of a rupee instead of meaning that it will command one rupee in exchange for itself for that is meaningless, we would mean that it would command so much of milk or butter or a bus ride to the country side in a certain market at a certain period of time By value of money is therefore, meant the purchasing power of money the capacity of a unit of money, to command goods and services in exchange for itself If prices are low, a unit of money will command more goods and services, if prices, are high, the same unit will command less goods and services And so, the value of money is related to prices When the general price level is high the value of money is low, when the general price level is low, the value of money is high

We come next to the question of measuring the value of money Since the value of money refers to its purchasing power and since the purchasing power of money in a given situation depends upon the goods and services which a unit of money will buy, the value of money can be found only by reference to the price of these goods and services But these goods and services, naturally enough, have different prices For purposes of measuring the value of money we need a single price many prices would mean confusion, a rupee purchasing more wheat and less cloth would be more valuable if the price of wheat alone was looked to and less valuable if price of cloth alone was considered We cannot make a general statement whether the value of money has gone up or gone down-unless we have a single price

The technique of index numbers—To do that, says Keynes, we find out the price of a composite commodity This composite commodity is a mere collection of all those commodities which a society buys for consumptiln wheat, cloth, fuel, etc and the like at any time We add up the individual prices of

For measuring changes from time to time in the value of money we calculate for each time a price level or an average price pertaining to the composite commodity (with its weights of importance) that happens to be the target of consumption at the time selected for purposes of comparison. When such a series of price-levels has been collected at one place, we call it by the name of index numbers. Index numbers are, therefore, a series of price-levels calculated from time to time for the *same* composite commodity for purposes of ascertaining the changes in the value of money. It should be evident why the composite commodity should necessarily be the same. If you want to know the changes in the price of *A* for two years, then you will naturally compare *A*'s price in one with *A*'s price in the other year. The comparison of *A*'s price in one year with *B*'s price in another is, in a way, completely meaningless.

The year with reference to which we measure changes in the price-level and hence the changes in the value of money is called the base year. If we wish to compare the value of money today with that in 1939, then 1939 would be the base year in our index-number. The prices in the base year would be taken as 100 and all the prices today would be expressed as a percentage of the base year prices. If wheat—the same quality one—were being sold at Rs.3 a maund in 1939 and at Rs. 12 a maund today, then its price in 1939 would be 100, and today 400.

Difficulties of constructing index numbers—It would be well to indicate some of the things which should be kept in mind while constructing the index numbers.

The first thing is the choice of the base year itself. The selection of a year as base which fell in abnormal times—times of depression or boom—would lead us to misleading results. If prices today are compared to those prevailing in the boom period of the middle thirties, they might appear as having only slightly increased. And we would say that money has not become really as cheap as it appears when we compare its purchasing power to that in 1939. For a correct understanding of the fluctuations in the value of money a normal base year, neither of boom nor of depression but the one lying be-between both, should be chosen.

The selection of such a normal year is, however, a difficult task. For, we cannot easily say when it is a boom, a depression or a normal period.

Theoretically speaking, the best price level is that which happens to be the average price of all such commodities as

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form part of the composite commodity But it is in practice difficult to include all commodities of consumption in a society they are so numerous and even within themselves so varying in quality that we cannot possible include all of them Thus the necessity is forced upon us of including only as many commodities as possible consistent with the fact of their being widely consumed at the same time If commodities are included which are not more or less universally consumed in the society, the price level thus calculated would be of no use though it would be indicative of the condition of those particular people who use those commodities Our eyes should be on the society as a whole rather than on a section of its people

A further thing that should be kept in mind is the type of prices collected for calculation If wholesale prices are averaged the result would be different from that which we would get if retail prices were to be averaged instead For, retail prices are generally different from the wholesale prices To know what a unit of money will buy to *X*, we must, if we are to be accurate, take into account the price that *X* actually pays in the market and this price in an overwhelming number of cases is the retail price and not the wholesale one To know what a unit of money will buy to the society we should therefore know the retail price of commodities which the members of the society actually pay as *X* does, in their everyday consumption

But retail prices are difficult to collect And even if they can be collected somehow, so varied are they in most cases that we do not know which single one of them to choose for purposes of totalling and averaging The wholesale prices are quite often uniform throughout the society or at least they are more uniform than the retail prices Moreover they are easy to collect We can approach big centres of trade where bulk purchases take place and know the wholesale prices much more easily than we can know the retail prices But wholesale price index numbers are, by nature, less accurate for measuring money value than the retail price ones

Yet another thing that affects accuracy of price levels is the method of averaging The most commonly employed method is that of simple arithmetic averaging in which prices are totalled up and then divided by the number of articles The geometric average is obtained by multiplying the prices and then extracting their root to the same number which articles of the composite commodity add up to The harmonic average is obtained by adding up the reciprocals of the individual prices dividing it by the number of articles and then finding out the

reciprocal of the final result again. If there are two numbers a and b, $\frac{a+b}{2}$ will be the arithmetic average, $\sqrt{ab}$ will be the geometric average and $\frac{2ab}{(a+b)}$ the harmonic one. This last one is obtained in this way : we first add up the reciprocals of a and b i.e. $1/a$ and $1/b$ which gives us $\frac{a+b}{ab}$; then we divide it by 2 (which is the number of articles) getting $\frac{a+b}{2ab}$ as the final result. We now take the reciprocal and it becomes $\frac{2ab}{a+b}$ which is the average that we referred to above.

The geometrical average often times leads us to greater accuracy but it is difficult to use. And so the arithmetic average is generally in vogue.

As to the consideration of weights of importance we have already seen it to be indispensible for purposes of calculating an accurate measure of the purchasing power of money. Index numbers calculated without "weighting" are a wrong tool for measuring money value.

All the time that we spoke about index numbers till now we were referring to those which indicated average price of a composite commodity consumed by the entire society. We can frame index numbers for different sections of the society also. The procedure would be the same ; only—and that is evident enough—that the average prices indicated in such index numbers would be no direct tools for measuring the value of money to the society as a whole. Such sectional valuation of money is obviously easier than the valuation for the entire society. Often times such a valuation becomes necessary also as for example when the problem concerns the raising or lowering of wages of the working classes.

Different varieties of index numbers—Index numbers can be of different varieties, according to the purpose for which they are framed. If they are required to measure the value of money from the entire society's point of view i.e. to measure the general purchasing power of money then we will have to frame the index numbers of a composite commodity embodying all social consumption. If we want for working classes we will have working class index numbers. If we want them for assessing the labourer's wage per hour, we will have the earnings standard. If we want them to indicate changes in the whole-

sale prices of certain staple commodities, we will have wholesale index numbers. If the object is to stabilise prices then a tabular standard comprising wholesale prices of chief commodities might be formed. And so on, the variety of index numbers depending upon the object for which they are being framed. It is obvious that all these various types of index numbers so formed differ from one another in their results, for all of them would be based on different composite commodities with different weights and prices.

EFFECTS OF CHANGES IN THE VALUE OF MONEY

When a unit of money buys less or more, all the members of the society either lose or gain and to the same degree together. But this state of affairs is evident when each individual price has gone up or down simultaneously with all other prices. Normally what happens is however different. Some prices rise more than others or fall more rapidly with the very obvious result that some gain more or lose more than many other people in the same society. It is worthwhile indicating the effects of price changes on the respective gains and losses of the various members of a society. These gains or losses might result from shifts in the real wealth and income of the people, and from fluctuations in the volume of employment and production owing to price changes. We shall, therefore, study the effect of changes in the value of money on (1) the distribution of real wealth and income and (2) the volume of employment and production.

We take up the effects on the distribution of real wealth and income first. These effects are attached to (*a*) debts incurred in money and also (*b*) the various types of money incomes to the society. When prices rise relative to a certain period of time, then he who is repaid his debts contracted in that earlier period is a loser in so far as the amount which he gets back purchases a smaller quantity of goods and services than it used to do before. If *X* who had lent out a sum of Rs 100 in 1939 to *Y*, gets back hundred rupees today he would be able to purchase much less with those hundred rupees owing to the prices being high at this time relative to those in 1939. And so *X* would be a loser. But *Y* will *not* be. In terms of goods and services *Y* pays much less in 100 rupees today than what he had got from Rs 100 in 1939. When prices rise, creditors of the period when there was no such rise, lose but *debtors* gain. The opposite happens when prices fall. For the creditors receive more purchasing power than they had lent out while the debtors pay more purchasing power than they had received at the time of borrowing their debts.

In the case of those whose incomes are almost constant or do not change very frequently, a rise of price means a loss while a fall of price means a gain. Take for example, interest, rent, pensions, annuities, salaries of public servants and to a small extent salaries and wage rates of workers in private industry. These do not fluctuate widely. And hence the obvious result that when the value of money has gone down, their money income being the same, the amount of purchasing power in their hands or their income in real terms goes down correspondingly and they stand to lose. But the receivers of profits of enterprise are not losers to a simi lar extent. In fact, they might even be gainers on the contrary. For, when prices rise their money incomes from profits also generally rise and so the net aggregate of purchasing power in their hands might actually increase. In periods of rising prices, therefore, the real income of capitalists, landlords and public servants generally goes down and they lose but the real income of entrepreneurs goes up or remains constant and they do not lose.

More far reaching and serious are the effects of price changes on the volume of employment and production in the society. These effects are to be studied through the behaviour of those who are responsible for production viz. the enterprisers. They open more factories, use more factors and raw materials, employ more people and produce more goods and services. And society to this extent gains in real income. When prospects of of profit are negative or zero, factories are closed down, factors are left idling, labourers are dismissed, production declines. And society to this extent is a loser in its real income.

Profits being the difference between the income and cost of the entrepreneurs, they would be high when income is high but costs are low, they would be low when income is low but costs are high. When costs are higher than income losses begin to accrue to the entrepreneurs. In a period of rising prices, we have seen that interest, rent etc. are almost constant whereas entreprisers' income increases a good deal. And so the profits of the entrepreneurs have a tendency to increase. The result is increased employment and production and hence increased real income to the society. In a period of falling prices, the opposite thing happens. The income of the entrepreneurs decreases with poorer prospects of profits with the result that factories begin to be closed down and labourers are dismissed, unemployment gets rampant, incomes of those who were employed just a while ago vanish, demand of goods decreases. And even those goods which are being currently produced (what to say of those that have already been

CHAPTER XXXXI

VALUE OF MONEY (*Continued*)

THE QUANTITY THEORY OF MONEY

Historical background. Economists for a long time past have been conscious of some relationship between money on the one side and prices of goods and services on the other. Of what nature this relationship is they are yet not completely agreed about. But a majority of economists of whom Fisher is the chief, has held the view that this relationship is such that when the quantity of money in circulation is increased other things remaining the same the value of money decreases or when the quantity of money in circulation is decreased, other things remaining the same the value of money increases. This is what is commonly described as the quantity theory of money.

The earlier and cruder forms of the quantity theory did not recognise the importance of the fact of money circulation. To them quantity of money in itself was a sufficient determinant of the price level. If this quantity increased prices went down; if it decreased prices went up and so on. But soon it came to be realised that prices would be determined by money that circulates rather than by money that is underground. Mill said, "If the whole money in circulation was doubled prices would be doubled. If it was only increased one-fourth, prices would rise one-fourth, Thus recognition of the fact of money circulation gradually emerged till it has come to be almost indispensable today in the explanations of the modern version of the quantity theory.

The reason why the fact of circulation of money is imporatnt is obvious enough. If one unit of money passes hands ten times it would increase demand for goods by the same number. As soon as a rupee is got want is felt to spend it on something. And every time that this rupee goes into a hand every time such a want arises so that a person who gets this rupee ten times feels ten times the demand that he would feel if he got this rupee once only. This increase in demand is in evidence when the same rupee passes on between ten persons. For then each one feels a demand to the extent of a rupee and so the total demand becomes ten times that which would have been felt had the rupee remained with the same person only. This increase in demand naturally affects prices. And so the fact of circulation

* This analysis follows Prof. Chandler's analysis in his book entitled 'Introduction to Monetary Theory'.

cash transactions; also again if T is the total volume of society's goods and services traded in exchange for society's cash transactions with P as the average price per unit of T, then we would say that $MV=PT$ in that society at that time. This is what monetary theorists call as an equation of exchange. It is with the help of this equation that they explain the quantity theory of money. In the long run, they say, an increase in the quantity of money causes an almost proportional increase in the price level. In the short run changes may not be proportional.

Let us, for a moment, digress to analyse the various factors that might cause fluctuations in M, V and T at any time or which is the same thing let us see the factors on which M, V and T depend.

M constituted of cash and bank deposits subject to check depends upon the following chief factors.

1. The size of monetary base.
   (a) the size of the monetary gold stock.
   (b) the amount of coins and paper money issued by the Government.
2. The community's choice as to the relative amounts of cash and of checking deposit that it wishes to hold.
3. The height of the ratio between bank reserves and checking deposits.

Monetary base is the fund out of which cash emerges either for circulation or for serving as a reserve against which notes or token money might be issued. It should be clear of itself that if this monetary base increases, quantity of money would also increase and vice versa. The most common form of monetary base is gold the stock of which inside a country depends on the country's internal production of it and the position of export of gold. If gold stock is sufficient. more cash in the form of standard and token money including notes would be available for circulation.

The next factor determining the quantity of money is the decision of the community itself as to how much Government money and how much bank money would it like to hold. If the community has decided to hold more money, there would be quite often, a condition of inflation; if it has decided to hold less money, the quantity of money would go down.

A third factor affecting the quantity of money available is the ratio of bank reserves to bank deposits. This factor has

a potent influence on the supply of bank money. Each bank, everywhere, is asked that if its reserve requirements are X then it should not open deposits of more than a certain multiple of X. It might be asked say for example, that if 20 is what it is required to keep as reserve, then it should not open deposits above hundred which is five times its reserve requirements. And so on. This can easily show that banks are prevented from opening limitless deposits and hence from issuing excessive amounts of bank money to the public. The temptation to offer loans at the time of brisk business might lead the bank to issue such excessive amounts: the ratio between reserves and maximum deposits serves as a check upon this temptation. For then they cannot issue money beyond that limit where this ratio has been achieved. The banks are, however, free to issue money below this ratio. Just what ratio there should exactly be between a bank's reserve requirments and its deposits depends upon what the law or custom wants it to be.

Next we come to V. V depends upon the following chief factors:—

(1) The stage of development of credit and financial system, and the community's use of it.

(2) The community's habit as to saving and consuming its income.

(3) The conditions of payments in the community.

(4) The means of transport, and

(5) Population.

A community with a good banking and credit system would be using money more freely than a community with no such system. There would not be any such fear that if all money is spent loans would not be available. And velocity of circulation of money would be naturally high. But the *mere existence* however, of an advanced system of credit would not of *itself increase* velocity unless people make frequent use of the system.

Velocity of circulation of money also depends to a considerable extent on the fact whether the community is thrifty and *wants to* save more or would spend a greater part of its income on consumption. *Naturally* enough, if people want to save *more, they would not easily part with* money, money would pass hands less frequently and its velocity of circulation would go down. The reverse will happen when people will be willing to consume more and hence easily part with money and money would pass hands more frequently.

Also important in connection with this velocity is the system of payments in the community. If payments are made regularly, people will spend money more freely than if they are paid in an irregular manner. If a labourer is not sure of whether he would get his next wages after a week or a month, he would naturally like to spend money with great caution but if he is sure of his payment, after a week or a month he may not be as cautious. And then the veloctiy of circulation of money owing to free expenditures would naturally increase. Again if the labourer, even when paid regularly, gets wages on a monthly basis, his expenditures would not be as frequent as they would be if he is paid on a weekly basis only. The more frequent the payment, the more frequent the expenditure and hence the greater the velocity of the circulation of money.

Velocity of circulation of money would be affected by means of transportation also. If a coin reaches Bombay, Calcutta and Madras, it would pass greater number of hands than if it reached Bombay only, assuming for a moment that each of these cities has the same volume of business population. Thus velocity of circulation of a unit of money depends upon the ease with which it can travel throughout the community.

Population affects velocity in the sense that if a greater number of people be there , money would pass more hands than if the number is small. A greater population would increase the velocity of circulation of money; a smaller population would tend to decrease it.

Next we come to see the factors behind T of the equation. T depends on the following chief factors :—

(1) Population and the natural resources of the community.
(2) The extent to which the factors of production happen to be employed.
(3) The business structure of the community.
(4) The extent of barter.

If population is great , manpower would be great and with an adequate amount of natural resources, it would be possible for the community to maintain a fairly high degree of the production of goods and services. The reverse will happen if the population is small and the natural resources too are insufficient. The natural resources here also include the amount of capital equipment and the state of technical knowledge in the community.

The chances for the physical volume of trade in goods and services to be great or small depend also upon the limit to which the factors of production already happen to have been used. If a large amount of factors is yet lying idle, T will increase rapidly, if only few of them are available for production, T will increase but sluggishly and so on.

The total volume of traded goods would be greater if there is a large number of traders rather than if there is not. And this depends upon the strucure of business in the community. If the business is in the hands of a few monopolists, there will naturally be fewer traders and hence smaller trade, if business is spread up between a large number of people, T will generally expand.

This digression has helped us to look into those ultimate factors on which changes in price level actually depend. M is only a superficial factor useful in so far as it condenses in a representative form all those factors on which it itself ultimately depends.

The quantity theory maintains that in the long-run when all adjustments have been made, price level changes in proportion to changes in the quantity of money. If the quantity of money is doubled price level would be doubled, if the quantity of money is halved price level would be halved and so on. This happens because in the long run, V and T in our equation $MV = PT$ are independent of changes in the quantity of money. As we saw above they are mostly determined by factors which have nothing to do with the changes in the quantity of money at all. Naturally then when M becomes $2M$, V and T remaining unaffected P must become $2P$ in order that this equation might hold good i.e. when M—the quantity of money—is doubled P the average price of a unit of T, the total goods and services must become double too.

But this analysis holds good for the long period only—a period in which all adjustments of short period fluctuations have finally settled down. In fact even in the long period sometimes V and T might permanently change owing to violent fluctuations in them in the short period caused by changes in the money supply. But roughly speaking, it might hold good in the long period that V and T are mostly independent of money supply.

As said above the modern version of the quantity theory does not deny the possibility of price level changing in greater or smaller proportion to the changes in the quantity of money

in the short periods. We shall now see how these non-proportional changes take place.

Let us first see what happens when the quantity of money is increased. Assume that the members of society after weighing a number of considerations had decided to have X amount of money with them. Now when money increases beyond X, they have more money than they want, and they would naturally like to spend it. The demand for goods would increase; so will increase the prices of them. Also when people are willing to spend money freely velocity of circulation increases. As prices increase, opinion grows that profits would increase and some people will spend money still more freely adding more to the velocity of circulation. Here on this side consumers fearing that prices might rise still further begin to purchase things for hoarding, thereby increasing their expenditures and with them the velocity of money circulation also. An increase in the quantity of money, we can see, thus, might cause an enormous increase in the velocity of circulation. The total of cash transactions also rises enormously owing to the increase in velocity.

But whether this would cause a proportional increase in price level depends upon the movement of T i.e. the total volume of trade done with those cash transactions. If T rises just as much as cash transactions have risen, the price-rise would be proportional; otherwise it would be non-proportional. The extent of the rise of T depends upon the amount of factors unemployed at the time the cash transactions are shooting up owing to the enormous increase in the velocity of circulation. If a large number of idle factors exists, T might increase more rapidly than V; and the increase in price would be lower than the increase in M. If less idle factors exist, T might increase less rapidly than V and the increase in price would be higher than the increase in M. The relation between T and the unemployed factors is obvious enough. Unless there are factors to produce, how can production increase ? And unless there is increased production how can the total trade of goods and services increase ?

There is thus no automatic relationship between the increase of M and the increase of prices in the short period. Prices may increase in a smaller proportion in the beginning when T increases more rapidly than V owing to the availability of unemployed factors. And they may increase in a greater proportion later when T rises less rapidly than V owing to a smaller availability of factors, a great part of them having been used up in the beginning of the trade expansion. The recognition of the importance of V in the short period is indispensable

which would buy this X. When prices rise and money becomes weaker in its purchasing power, more money would be demanded to purchase X than before. When prices fall and money becomes stronger in its purchasing power, less money would be demanded to purchase X than before. The demand for money varies with the price level.

Here, however, price-level was the cause and demand for money the effect. We have to proceed in such a manner that the demand for money becomes the cause of price changes. Here we take then the changes in the demand for money independent of the price level and then study the effect of these changes on prices.

Demand for money may change for any of these two reasons or both. It may change (i) owing to changes in the trade of goods, services and securities per unit of time or (ii) owing to changes in the length of time for which the community demands money for making its purchases. The greater the volume of goods to be traded, the greater, other things remaining the same, would be the demand for money. Also the greater the period of time for which the community wants to hold its money the greater will be its demand for it. A community which wants to spend money on a month to month basis would be demanding less money than one which wants to spend money on a two monthly basis. It should be evident that when money is demanded to be spent on a month to month basis, the expenditures would be more frequent and hence the velocity of circulation of money greater than when money is demanded on a two-monthly basis. Assuming K to be the period for which money is demanded, the greater is K, the smaller is V and vice versa. Also the greater is K, the greater is the demand for money. The demand for money varies directly whereas the velocity of circulation of money varies inversely with K.

Suppose now that M is the total quantity of money supply in the society, P the average price per unit of T, the total trade in goods and services per year and K the length of time for which money is demanded. Then PT would represent demand for money for an entire year and $PT \times K$ or PTK would represent the demand for money for the period K (K being expressed in terms of years. Generally, however, K is only a small fraction being equal to a few weeks or months of a year). The supply of money is M; the demand for money is PKT. The value of money at the point of equilibrium would be such as to equate supply and demand. And so at the point of equilibrium

the community feels that it has a surplus over the present supply which it should use up in purchasing goods and services; the expenditures of the people go up and prices rise till the purchasing power of the existing money supply is lowered to the level demanded by the community. The increase in the price-level we might observe here should be proportional to the decrease in the demand for money, otherwise the same supply of money as before would purchase less or more amount of goods than the community demands. And at the point of equilibrium such a situation is impossible. In the interest of equilibrium, therefore, when the supply of money does not change price increases or decreases must be proportional to the decreases or increases in the demand for money. We give no separate treatment to what would happen when demand for money increases for it is just the opposite of the earlier case.

All this happens in the long run. In periods of transition, however, prices may or may not be proportional to changes in the supply of or the demand for money . The extent of price changes will depend upon the relative movements of T and K (in the transactions type of quantity theory we saw that they depended upon the relative movements of M, T and V). Since $K = I/V$ here, the analysis given in case of the earlier theory would apply here too with only that much difference which the relationship between K and V implies by assumption.

The supporters of the cash-balance type of quantity theory claim that their own explanation of the process by which money value is determined is superior to the cash transactions approach because of two chief reasons. One is that their theory is in harmony with the general theory of value which explains the determination of any value in Economics as a result of the interaction of the forces of supply and demand. The other reason lies in their connecting the problem of the valuation of money with the direct force of subjective valuation. Just what money would purchase does not depend on remote trade transactions but on the immediate decisions of human beings to have a certain amount of real income with them.

We may not dispute the claims of these supporters but we can frankly tell them that the substance of what they talk about is essentially the same as the one which the "cash-transactions" theorists too talk about.

Saving and Investment Theory

To a good number of modern monetary economists this way of approaching the problem of the value of money looks

goods and services. Thus, the total amount that the society A spends upon the purchase of T goods and services, consumption and production, out of its income Y is equal to P_1T_1 plus P_2T_2. If one unit of T is priced at P in the market then PT is the measure of the total expenditure of the society in purchasing T goods and services. But since P_1T_1 plus P_2T_2 is also a measure of the same expenditure we would say that PT equals P_1T_1 plus P_2T_2.

Now, if N is the amount of money that is saved (these monetary economists define savings as that part of income which is not spent on consumption goods and services), then Y minus N is obviously the amount of money that is used up in purchasing consumers' goods and services. Hence, $PT = Y - N + P_2T_2$

or $P = \frac{Y}{T} + \frac{P_2T_2 - N}{T} \ldots (a)$

Since Y is the money cost of producing T goods and services, Y/T is evidently the cost per unit of T which is the same thing as cost per unit of output produced by the society in the period K.

We can see now from the equation (a) that when

$$N = P_2T_2, \quad \frac{P_2T_2 - N}{T} = 0$$

so that $P = \frac{Y}{T}$

When $N < P_2T_2$, $\frac{P_2T_2 - N}{T} > 0$ or a positive quantity so that $P > \frac{Y}{T}$.

And when $N > P_2T_2$, $\frac{P_2T_2 - N}{T} < 0$. i.e. negative, making $P < \frac{Y}{T}$.

Now, P_2T_2 is the amount spent on production goods and services and N is the amount that is saved. Substituting words for symbols in the above conclusions, if the entire amount saved equals the amount spent on producers' good and services, the price per unit of T equals the cost per unit of T. There will be no profit or loss and production will be in equilibrium. If the whole amount that is saved is not used up in purchasing producers' goods and services but only a part, then, the amount spent on producers' goods and services will be less than the total amount saved. The price per unit of T will be less than the cost per unit and there will be losses. The output will

CHAPTER XXXXII
FOREIGN EXCHANGE

When a rupee is paid to an Indian merchant in exchange for the goods and services bought from him, he would readily accept it for it is a legal tender and passes from hand to hand without difficulty. But when a rupee is paid to an English merchant in exchange for his goods and services, he would refuse to accept it as he could not with that rupee buy anything in his country. A different currency, viz. the £ is in use there. This fact of the non-acceptance of the Indian rupee by an English merchant, however, does not prevent an Indian from buying goods in England ; it only makes less simple the problem of payment. The Indian merchant will have to get his rupees exchanged for a certain number of £s first and then pass these on to the English merchant. Foreign exchange refers to the fact of paying the foreigner certain amount of one's own currency after it has been exchanged into the currency of the foreigner. The precise meaning of the term "foreign exchange", however, varies with the context in which it is used. If we say that India needs today such and such an amount of foreign exchange to buy capital abroad, we mean by it the amount of foreign currency that India would like to exchange for her own currency for foreign payments. If we say that the foreign exchanges of India have not been widely fluctuating for some time past, we mean that the rates of exchange between the rupee and the foreign currencies have been almost constant. Foreign exchange also refers sometimes, to bills of exchange and banker's drafts etc. And sometimes it might refer to the mechanism through which trade accounts are adjusted between the various countries of the world.

The necessity for exchanging rupees into £s arises because the rupee is not a legal tender in England. Had there been a coin or currency that was legal tender in all the countries of the world, the necessity of such an exchange would have disappeared. But there is none such unfortunately. The U. S. A. once made a proposal that all the countries should use an international monetary unit called "Unitas" (consisting of 137½ grains of fine gold). The United Kingdom made a proposal that all the countries should use a currency called "Bancor". But neither of these proposals materialised. And each country of the world continues to follow the same rut of exchanging

one currency [illegible] to the foreigners to make payments to the latter.

Rate of exchange under a gold standard.—The question that crops up [illegible] is: How does a country decide the rate at which own [illegible] is to be exchanged for the foreigner's? Or in other words, [illegible] the theory of the determination of the rates of exchange between the countries of the world? When the countries concerned happen to be on a gold standard the determination of such rates, provided there is free movement of gold between them, is easy and automatic. Haberler says, "If two or more trading countries are on the gold standard, and if there are no obstacles to the import and export of gold, then the different currencies are rigidly linked together. For instance, if an ounce of gold can be coined into a definite number of pounds sterling and into twenty times as many marks then on the provisional assumption that no costs are involved, one can convert at will 20 marks into 1 £ and vice versa." And the rate of exchange is thus automatically fixed at 1 £ = 20 marks.

A gold standard says Harberler "in the narrower sense signifies a monetary system under which gold coins of standard specification or gold certificates with 100% gold backing form the circulating medium. In the wider sense it covers all those cases where notes or silver coins are legal tender provided they are convertible into gold at a fixed rate. There must of course, be no prohibition of the melting down of gold coins."

What happens if the rate of exchange in the countries referred to is not 1 £ = 20 marks but something else? Suppose that it is 1 £ = 18 marks *only*. People now, in the country where marks constitute the currency, will like to exchange marks for £s, convert £s into an equivalent amount of gold, and get that gold converted into marks again. Suppose one ounce of gold is equal to X £s in one country and as said above to 20 X marks in another then the rate of exchange should be 1 £ = 20 marks. If it is 1 £ = 18 marks then people will sell 18 X marks for X £s, obtain an ounce of gold for those £s and have it converted into 20 X marks again. They spent 18X marks and get 20 X marks, making thereby a profit of 2X marks on the transaction. When a large number of people thus begin to convert marks into £s to make profit like this, the value of the £, owing to increased demand, supply remaining the same, will go up till 1 £ = 20 marks in the end. If the rate is 1 £ = 22 marks, the opposite process would set in. The demand for marks would increase, the value of marks would

go up till 1 £ = 20 marks again. Eventually then the rate of exchange under a gold standard, with free convertibility between currency and gold and unchecked flow of gold between the trading countries would necessarily be such that one unit of a country's currency would be convertible in the same amount of gold in which those numbers of units of other countries' currencies to which the one unit of the former country's currency is equal would also be convertible.

Under a gold standard, the problem of payment can be greatly simplified provided there is ample supply of gold available for making payments. For then if some one in Germany purchased X £s worth of goods from an English merchant, he will at once ship him an ounce of gold which when got converted into £s will make the merchant there the wanted number of £s available. So also can an English buyer send gold to a German merchant for the goods purchased from him.

The technique of foreign bills of exchange—Ordinarily gold is not thus transported. There has been in fact a growing tendency to economise the use of gold in international payments. The next course open, then, to take up our own example, is that the German merchant should purchase £s at the rate of 1 £ = 20 marks and make payment to his English creditor, for the goods that he has bought from him. In reality, however, even this may not come to pass. Owing to the use of foreign bills of exchange and the presence of a larger number of buyers and sellers of English and German goods in both these countries, the necessity of exchanging marks for £s and £s for marks might be greatly obviated. We shall see now how this happens but before we do that, we better understand that chief instrument with the help of which international transactions are settled. This instrument is called the foreign bill of exchange. A foreign bill of exchange is a claim drawn by a seller upon a foreign buyer for the amount for which he has sold his article to the latter. This claim should be fulfilled within the period of time for which the bill has been drawn. There are three main points of difference between a cheque and a bill of exchange. A bill will be drawn on any one who owes a debt to the drawer whereas a cheque is ever drawn on a bank only. A bill is payable on maturity (unless it is a sight bill) i.e. when the time for which the bill has been drawn just expires but a cheque is payable at sight. A bill will have validity only when it has been "accepted" by him on whom it is drawn ; a cheque needs no such "acceptance",

The use of foreign bills implies the avoidance of actual exchange of currencies. Suppose that a German buyer has placed an order for goods worth £1000 with an English merchant. The English merchant will then draw upon this German buyer a bill claiming £1000 from him for the sale that he makes to him and send this bill for acceptance to him. The German buyer will write the word "accepted" and sign it on the bill and send it over to the English merchant who has now the promise in writing from him that he would pay him £1000 when the bill is presented to him after maturity.

Suppose also that there is an English buyer who has bought goods worth 20,000 marks from a German merchant. There are now four parties to settle their account. The English merchant and the German buyer, the German merchant and the English buyer, two of these having claims for payment and two having obligations to pay.

Now this is what generally will happen. The English buyer who has to make the payment of 20,000 marks to some German merchant will meet the English merchant who claims £1000 from some buyer in Germany and purchase from him the "accepted" bill of £1000. He will then send this bill to his creditor in Germany who owes him 20,000 marks with instructions to present this bill to the German buyer of the English merchant's articles and get from him the 20,000 *marks* that are his due. Thus we see that the English merchant has received his £1000, and the German merchant his 20,000 marks. The English buyer has paid 20,000 marks (when he puchases the English merchant's bill for £1000) and the German buyer has paid £1000 (when he makes payment to the German merchant.) The *entire* transactions are settled with the mere transportation of a *single* bill of exchange from England to Germany. And no *necessity* of bothering to obtain marks for £s and £s for marks ever arose.

As in the case of these *four* parties of our own example, so also in an extended case where *hundreds* of parties are engaged in buying and selling their respective goods and services, accounts generally tend to be settled with the assistance of the foreign bill market. They are the suppliers of the foreign bills who owe money abroad and they are *those* who demand such bills who have to pay money to the foreigners. It may be that the supply of foreign bills at any time falls short of the demand for it—there are more people who have to make payments and less who have to claim. Or the supply may be greater than demand implying larger number of those who have to claim payments

abroad than of those who have to make their payments. We shall analyse both these situations. Let us take that situation first in which the demand for foreign bills is greater than the supply of them.

Disparity between exports and imports and its impact upon the rate of exchange—We now get back to our earlier example of Germany and Great Britain with gold standard working at 1 £ = 20 marks. Suppose that there are less German exporters to England than there are German importers of the English goods. The supply of foreign bills on England, therefore, would be less than the demand for them, there being more of those who have to pay to England than of those who have to receive from that country. Now if German importers do not buy these foreign bills on England but transport gold instead to that country for paying off their debt, there must be some transport charges also incurred in gold transportation. Suppose that the transportation charges of gold per £ to England is ½ a mark. Then for every parcel of gold sent, the German importer will be a loser to the extent of ½ a mark per £ and the rate for him would really be 1 £ = 20½ marks, rather, than 1 £ = 20 marks. The German importer, who cannot have foreign bills on England in abundance, will think twice before he is willing to incur a loss of ½ a mark per £.

Here on this side, the supplier of bills on England seeing a scramble for their bills amongst the German importers will like to exploit the situation by charging a larger number of marks for the same number of £s than before. This they can do when they ask the buyers of their bills to pay not at 1 £ = 20 marks rate but at a rate which is higher than this.

Let us suppose that they demand the rate 1 £ = 21 marks from the buyers of their bills. Will the buyers agree to this rate? No. If they do not buy these bills and send gold instead, they would be paying back their debt at 1 £ = 20½ marks only. Why should they agree to buy the bills at a rate more unfavourable than this? Suppose the sellers of the bills are willing to sell their bills at 1 £ = 20¼ marks. Will the buyers agree now? Yes, they will because they spare themselves the loss of ¼ mark per £ which direct transportation of gold would have involved them in. So long as, in the situation of the supply of bills on England being less than the demand for them, the rate of exchange is less than 1 £ = 20½ marks, the German importers of English goods who have to make payment for these goods to the English merchants will find it less advantageous to export gold and would rather buy these bills from the German exporters. When

is the gold import point or upper specie point for Germany is the gold export point or the lower specie point for England ; that which is the gold export point or the lower specie point for Germany is the gold import point or the upper specie point for England. The rate of exchange rises above the gold export point when the supply of bills is greater than the demand for them and secondly there is difficulty in obtaining gold from England for importation. The rate of exchange falls below the specie point when demand for bills is greater than the supply of it and secondly there is difficulty in obtaining gold for exportation. It can be easily imagined now that in face of the growing Indian demand for American goods rupee would have easily passed below the specie point had the perfect conditions of an international gold standard prevailed. The demand for bills on America being greater and gold being not easily obtainable for exportation, what else could have been the result ?

Now when the rate is tending towards 1 £ = 19½ marks or beyond, we have seen that it is tending to be favourable and the situation is characterised by a supply of bills greater than the demand for them; exports from Germany to England are greater than the imports from England to Germany. But when the rate is 1 £ = 19½ marks or about that, a reverse process comes in evidence; the imports begin to increase and exports go down till exports and imports have become equal; there is the same supply of bills as there is the demand for them and the rate is once again set at 1 £ = 20 marks.

Why does this happen ? Because £ has become cheaper and the German merchants naturally want to take advantage out of it. For the same thing which costs 1 £ they were paying 20 marks before; but they will pay only 19½ marks at this time. And so a tendency sets in to import goods from England into Germany for they are cheaper now in terms of the German marks. Imports to Germany move up and there appear more of those who demand foreign bills of exchange on England.

On the other side in England, there is a tendency for the English merchants to export more and more to Germany. Formerly when they sold an article worth 20 marks in Germany, they got 1 £ only; now when they sell the same article worth 20 marks in Germany they get more than a £. Exporting becomes more profitable to England than importing from Germany. Thus we see that both in England as well as in Germany, tendencies begin to work to set right the disturbed trade balance between their respective exports and imports. In Germany imports increase and hence the demand for foreign

This buying and selling of currencies in advance is known as "forward exchange" business. "Forward exchange" as we have seen above is a device to get rid of losses resulting from fluctuations in exchange rates.

Exchange ratio without gold standard. After this digression we come to the consideration of the determination of exchange rates again. Under a gold standard we saw that the problem was simple. What happens when the conditions of gold standard do not obtain ? Ever since gold standard went out of fashion amongst some of the leading countries of the world, economists have been greatly in search of a correct theory explaining the determination of foreign exchange rates.

The theory of absolute purchasing power parity. Two explanations or theories have been advanced. The one is the theory of purchasing power parity and the other that of the balance of payments. We shall take up the purchasing power parity theory first.

If 1,250 dollars buy a certain amount of goods and services—wheat, shirts, houses, etc. in the U. S. A. and 100,000 francs buy the same amount and quality of goods and services in France, then the rate of exchange between France and the U. S. A. would be 1,250 dollars = 100,000 francs or 1 dollar = 80 francs. The equilibrium rate of exchange will be such that one unit of a country's currency will buy the same amount of goods and services which so many units of another country's currency, to which it is equal, will buy on their own soil. In other words, the rate of exchange will be such that the two sides to it have the same purchasing power. The rates of exchange will equalise or establish a parity between the purchasing powers of the currencies of the trading countries on their respective soils. This is what is popularly known as the absolute purchasing power parity theory. The theory is greatly associated with the name of Gustav Cassel who made it popular. Just as under a gold standard, the equilibrium rate of exchange is achieved at the point of mint par where the two sides to the rates represent the same amount of gold in them, under non-gold standards, the equilibrium rate of exchange is achieved at the point of the par of purchasing powers of the two sets of currencies indicated in the rate.

Now then, we saw above that the rate of exchange between U. S. A. and France should be 1 = 80 francs, for then alone it will establish purchasing power parity. What happens if the rate is 1 dollar = 70 francs ?

A man with 70 francs will obtain a dollar in exchange for his own money, purchase with this dollar a certain amount of goods from America and sell these goods at 80 francs in France, thereby making a profit of 10 francs on the transaction (Goods worth a dollar must obviously sell at 80 francs in France for this is what we have assumed in our example) Many merchants would begin to earn profits in this manner Naturally then the demand for dollars in terms of francs would increase and the price of dollars in terms of francs would go up too Eventually one dollar will exchange for 80 francs If the exchange rate is 1 dollar = 90 francs, a process opposite to that analysed above will set in tending to drive the rate at 1 dollar = 80 francs again this time of course, the ball will be set rolling by the United States merchants, their demand for francs would increase for francs are cheaper now, till the value of franc has risen high enough to reach the equilibrium level

We thus see say the supporters of the theory that the rate of exchange will be in equilibrium only when the two sides to it represent equal purchasing power If a different rate is established, it will ultimately tend to approach the equilibrium rate Just as fluctuations tend to correct themselves under a gold standard, they tend to correct themselves under non gold standard conditions also Only that whereas fluctuations under a gold standard confine themselves within the limits set by the specie points, fluctuations here do not lie limited within any definite points

The theory of absolute purchasing power parity has been found unacceptable for the following reasons First, it assumes that when the rate of exchange is 1 dollar = 70 francs French merchants who have spent 70 francs on a dollar and purchased American goods with it will be able to get these goods easily into France for purposes of selling them for 80 francs again How can a house be had from the United States? The greater the number of goods of this type the less will be the chances that French merchants would demand dollars for buying goods in America and selling them into their own country, naturally then the less also will be the rise in the value of a dollar and it may be that once disturbed the dollar may never touch 80 francs level again

The demand for a dollar depends upon the demand for goods which can be traded with between France and the United States As a more extended statement we would say that the demand for the currency of any country is linked up with the

demand of only those goods of that country which can be and are internationally traded. And it is such goods that can influence the value of the dollar. But here too sometimes the influence is not so definite as to push up the exchange rate necessarily to the equilibrium level in the end. When the rate is 1 dollar = 70 francs, the demand for dollars may not be so great (for there may not be any large number of merchants eager to have wheat, cloth or steel from the United States) as to push up the value of a dollar to 80 francs in the end. This lack of demand might be due to the fact that there is only a smaller number of merchants in France willing to buy and sell internationally traded goods. It might also be due to the fact that transportation charges from U.S.A. to France are so high that if goods are resold in France, they leave no margin of profit at all on the francs that were spent to buy dollars and with them the American goods.

The theory then is difficult to apply in practice. We cannot easily compare the purchasing powers of a dollar and a franc. A dollar is spent on different qualities and quantities of goods and services; and a franc on different ones. If one dollar purchases X and 80 francs purchase X_1, how can we say that 1 dollar = 80 francs ? This would be possible only when 1 dollar or 80 francs both purchase X only. In reality despite all superficial similarities, these Xs would not be the same. And yet the charge that the theory is impracticable is no charge in a way. Much of what is theoretical is impracticable.

A second version of the theory. A second version of this theory is less pretentious. The first version—the absolute purchasing power parity theory—which claims that it can help to determine an equilibrium rate of exchange, is, as our analysis shows, not satisfactory. The second version, we shall presently see, is also not quite acceptable. It does not claim much; it does not, say, for example, that it can explain an equilibrium rate of exchange; it only says that when changes take place in the purchasing power of a certain currency relative to the purchasing power of another, the equilibrium rate of exchange fluctuates in a certain manner. Thus it only explains the changes in the equilibrium rate of exchange when the price levels in the trading countries have changed relative to each other. It assumes, rather than explains the equilibrium rate of exchange.

Suppose that the equilibrium rate between India and England is 1 Re. = 1 sh-6d. Suppose also that when compared to a base period prices in India have risen four times and those in England have risen cent per cent so that a rupee buys one-fourth and a

£ one half of what it did before The increase of prices in India *relative* to England is twice the increase in the English prices The same article which cost X rupees before would be available at $2X$ rupees now The English merchant is clever enough not to pay $2X$ rupees he will so adjust his rate of exchange with India that the same number of £s which equalled X before would equal $2X$ now so that for this change in the Indian prices he is not a loser When the price increase in India is double relative to the price increase in England we see thus that the external value of the rupee in terms of £ becomes $\frac{1}{2}$ of what it was before Rs 2 would equal 1sh-6d or the rate of exchange would be 1 Re=9d If the price increase in India is three times that in England the external value of the rupee in terms of £s will fall to one third and so on But this implies one very important assumption—that the elasticity of the demand of the English merchant for Indian goods is unity He spends the same number of £s as before only that the rate now is such that when converted into rupees, these £s bring him the same articles or goods which he was buying with these £s at the earlier rate and the earlier prices

Put in a mathematical form

$$\begin{array}{l}\text{The present}\\\text{price of a rupee}\\\text{in terms of}\\\text{English currency}\end{array} = \begin{array}{l}\text{Exchange}\\\text{rate in}\\\text{the base period}\end{array} \times \frac{\text{Present British Price Index}}{\text{Present Indian Price Index}} \times \frac{\text{Base Indian Price Index}}{\text{Base British Price Index}}$$

This formula can be used for evaluating any rate of exchange provided we make proper substitutions If the equilibrium rate of exchange is 1 Re = 18d, the base Indian price index is 100, the present Indian price index is 400, the base British price index is 150 and the present British price index is 300, we will get the present price of a rupee in terms of English currency at 1Re=9d

This version of the purchasing power parity theory is unacceptable for the following reasons —

It assumes rather than explains the equilibrium rate of exchange

Secondly, its analysis is based on price indices of individual countries in which most of the goods are those which do not enter into international trade And we have seen above that only goods which are internationally traded have impact on the problem of foreign exchange determination

Thirdly, the analysis assumes that the elasticity of the demand of the foreign merchants for a country's goods is unity This

is not necessarily the case. When prices in India rise relative to those in England, the amount which English merchants are willing to spend on Indian goods can easily be different from the earlier one and the elasticity of the English demand for Indian goods would cease to be unity then.

Fourthly, just as the price-level influences the exchange rate, the exchange rate might also influence the price level. And in that situation the theory becomes absurd. When a country's currency has depreciated, an increase in exports might lead to the search of cheaper means of production and hence to lower prices.

Fifthly, the rate of exchange is determined as much by capital movements and speculative activities of those who deal in foreign currencies as by the sale and purchase of goods and services. This theory seems to assume that the rates of exchange are determined by the movements of goods and services only and of course, by the movement of their prices.

Lastly, there is an assumption in the formula above that exchange rates are determined by the movement of prices in such a manner that all go up or down in an equal degree. This, however, may not and, in fact, often times does not happen. One price may change more than another. And hence foreign expenditure on one article may be greater than on another and differently affect the exchange rate, though price change has not distributed itself equally over all articles.

Balance of payments theory. We take up now the theory of the Balance of Payments. Some economists have maintained that the rate of foreign exchange is determined by a country's balance of payments. A balance of payments is a brief statement of the foreign economic dealings of one country say *A* with another country say *B*. There are two sides to this statement. The one is that which shows what *A* is to receive from *B* and the other which shows what *B* is to receive from *A*. The amount which *B* is to receive from *A* represents *A*'s supply of its own currency in terms of *B*'s. *A* will naturally be willing to supply that much of currency to *B* which is necessary to pay *B*. The amount which *A* is to receive from *B* or which is the same thing which *B* has to pay to *A*, represents *B*'s demand for *A*'s currency in terms of its own. The balance of payments represents thus the supply of and the demand for *A*'s currency in terms of *B*'s. The rate of exchange of *A*'s currency for *B*'s say the supporters of this theory, will be determined by the forces of the supply and demand of *A*'s currency.

A's balance of payments would approximate the following typical form*

On the credit side the following will be stated

(*a*) Exports of merchandise to *B*
Expenditure of the tourists from *B*
Ocean and air transport services rendered to *B*
Banking and insurance services rendered to *B*
Interests and dividends received from *B*
Emigrant remittances to *B*
Expenditures of *B*s government in *A*

(*b*) Imports of capital

(1) Longer term capital

(i) New securities belonging to *A* sold to *B*

(ii) *B*s direct investments in *A*

(iii) Sale to *B* of outstanding securities belonging to *A*

(2) Short term capital

(i) Increase of bank balances owned by *B* in *A*

(ii) Reduction of *A*s balances in *B*

(*c*) Exports of gold

(i) Physical export of the metal

(ii) Reduction in *A*s gold on earmark in *B*

(iii) Addition to *B*s gold on earmark in *A*

On the debit side the statement will indicate the opposite of these items e g imports of merchandise from *B*, exports of capital to *B* imports of gold from *B* and so on

It should be clear from this classification that the balance of trade and the balance of payments are not the same or identical Of course the balance of trade does form a vital and generally a major part of the balance of payments

The necessary thing to know in this context is the fact that the total amounts on both sides of the balance of payment must inevitably tally The credit and the debit side must necessarily balance And since the credit represent demand for *A*s currency and the debit the supply of *A*'s currency for *B* the supply and the demand for *A*'s currency for *B*s indicated in the balance of

* See Enke and Salera 'International Economics

payments must obviously always be equal. A country's balance sheet shows what it is getting and spending at the same time. Its spending cannot for all times be greater than what it is getting. Nor can its spending be for ever less than its income. All that happens is that when surplus money cannot be used by a country anywhere else, it is spent in advancing loans or (though that seldom happens) in hoarding. International borrowing or lending automatically occurs to bring about equality between the credit and the debit sides of the balance sheet when other items fail to bring about this equality.

When this is the situation, then, the balance of payments theory might naturally appear axiomatic. For, it seems to maintain that automatically and always the income and the expenditure sides balance each other. There is no possibility of a country having a balance against or in its favour. The rate of exchange, it might then seem to follow, has hardly any part to play in bringing about this equality.

This however is not a valid objection to the balance of payments theory. For one thing, it is logically the most correct theory as it is based on the most fundamental law of supply and demand. It says that the price of a country's currency depends on the demand and the supply of that currency. We cannot criticise this theory without criticising at the same time the very foundation of the Theory of Value.

Moreover, it must be noted that when we say that the two sides of the balance sheet are always and automatically equal we are paying little attention to the role of the rate of exchange. It is through this rate of exchange that the equality is brought about. Each country has its bills made out, as it were, in terms of its own currency. And we cannot say whether the bills of the two counties are equal unless we know the rate at which one bill is to be converted into the terms of the other. It is here that the rate of exchange comes into the picture. At any given rate of exchange this equality may not be achieved. When such is the case, one of two things must happen. Either the rate of exchange must change in such wise as to bring about this equality, or the balance must be treated as an invisible export from one country to the other ; that is, it must be treated as a loan from one country to the other. In reality both these things happen in most cases. Thus, the rate of exchange and balance sheet act and react on each other. Finally, the rate must be such as to balance the account,

And it is only this that is implied when it is said that the rate of exchange is determined by the balance of payments

Both the purchasing power parity and the balance of payments theories possess importance The latter, as we have just remarked, is the most fundamental and is based directly on the demand and supply theory of value Like all fundamental statements, it therefore, becomes axiomatic But truth must be self evident The purchasing power parity theory is, by contrast, less fundamental in character. But for that very reason it often becomes more useful in practice For instance, it draws the attention of a government most pointedly to the fact that inflation has its effects on the foreign rate of exchange For a country, therefore, that wishes to adopt a certain policy in regard to the rate of exchange it is imperative to pay attention to its internal price level

PART VIII

Credit and Banking

CHAPTER XXXXIII

CREDIT AND CREDIT INSTRUMENTS

None, but 'currency cranks', attaches to currency at present that supreme importance which it was imbued with a century ago. So vast and sweeping have been the changes which our world has witnessed in recent years that currency has now become simply 'the small change' of credit. Banks, not governments, are now the principal creators of money. No doubt, the national government still declares and ordinarily issues the standard money and fractional currency of a country but it delegates to the central and commercial banks the right to issue the chief kinds of money. No doubt we still continue to purchase cinema tickets and our daily supplies of commodities like fruits and vegetables with currency but their value is only a small fraction of the amount for which securities and other commodities are daily bought (specially in the wholesale market) on credit with credit instruments which are simply written evidences of antecedent credit transactions. These important sinews of modern trade and industry—credit, evidences of credit and creators of credit form the subject matter of this chapter.

Definition and nature of credit. In ordinary language, credit (derived from the word 'credere' which means 'to trust') connotes simply faith, belief or trust, but in Economics this word is used in a technical sense to denote the ability of a person to infuse in another person that confidence in his ability to pay and in his honesty which enables him to obtain from this other person a thing of value such as goods, services, money, or good-will, without making an immediate payment of its equivalent, by simply making a promise to pay the same at some future date. The credit of a person is measured by the amount which he can borrow from others. From the lender's point of view, it is a right to receive payment, and from the borrower's point of view, it is an obligation to make payment on demand or at some future date on account of the transfer of goods, services, money or good-will to him at the present time. In other words, what is debt from the debtor's point of view is credit from the creditor's point of view. When a banker says that he has allowed a credit for rupees five lacs he signifies that he has a right to receive this amount from his debtor. On the other hand when a businessman says that he has obtained a credit for rupees one lac, he expresses his indebtedness to that

extent Credit is, in a sense, a lending operation, involving postponed payment, or a protracted exchange In other words it is a transfer of value involving the return of its equivalent in terms of money in future

Is credit capital ? In the words of Ricardo, Credit is the means which is alternatively transferred from one (owner) to another to make use of capital actually existing, it does not create capital it determines only by whom that capital shall be employed According to J S Mill' Credit being only the permission to use the capital of another person, the means of production cannot be increased by it, but only transferred"

Credit no doubt, enables capital to flow from a person who owns it to another who can put it to a more profitable use, and, therefore, it increases the productivity of capital

Does the creation of credit then ultimately result in the creation of additional capital goods or wealth ? Generally speaking, it does thus only indirectly through a rise in price which reduces consumption and stimulates production, and directly where credit draws out hoarded wealth for being employed productively Fresh capital goods are then created and the volume of capital available in the community is increased But credit can increase pure capital too besides increasing capital goods For, a credit instrument serves the same purpose as cash It adds to the supply of purchasing power available to the people and thereby directly increases the quantity of capital

Distinction between credit and credit instruments Credit, we have seen, is an abstract thing or a belief which results in lending something of value or in an arrangement for deferred payment, but credit instruments are the tangible and visible written evidences of antecedent credit transactions They are written promises to pay a specific sum of money on demand or on some future date They take several forms, such as cheques, drafts hundies, promissory notes, postal orders and money orders These credit instruments, not credit itself, serve as important media of exchange and influence the price level

Essentials of credit Confidence, amount and time are three essential elements of credit (1) An essential part of a credit transaction is the transfer of goods to the borrower on an obligation to return an equivalent value (not the identical goods themselves) in the future Without such a transfer of value from one person to another, the question of postponement of payment and granting of credit does not arise Before allowing such a transfer of value, the lender must have confidence

in (i) the ability of the borrower to pay and (ii) his intention to pay. The confidence which forms the basis of all credit is based on the value of the property which the borrower possesses or is likely to possess and on the character of the borrower himself and of his business. For assessing the customer's character bankers investigate into (a) his personal habits, extent of his addiction to drinking and gambling, his own and his wife's style of living, his social ambitions and his religious affiliations, (b) his age and general experience, his intelligence, commonsense and shrewdness, his reputation for ability as judged by the extent of his success in his own business and side-businesses, (c) his past record for honest dealings. Bankers form an idea of the character of a customer's business by taking into consideration (i) the ratio of quick assets to current liabilities, (ii) the amount of capital invested in the business and the proportion which is self-owned, (iii) the character of goods stocked, (iv) the rate of turn-over of the stock, (v) the location of the business and the extent of competition which the business has to face there and (vi) the sum for which the business-house is insured.

(2) Moreover, the debtor's obligation should be capable of being expressed as a definite amount of money. The credit position of one person differs from that of another person, and various persons enjoy credit up to varying amounts.

(3) The element of time is an essential ingredient of every credit transaction. This element is introduced whenever payment is postponed and credit is allowed to a customer. With an immediate payment, the transaction becomes a cash transaction. Moreover credit is allowed by a shopkeeper or a banker to different persons for varying periods of time up to which it may be considered safe to lend to each of them.

Functions of credit. The chief function of credit is to transfer capital from those who possess but are unable to use it to the persons who expect to make a profitable use of it. Credit enables banks to collect balances from numerous depositors scattered over a wide area and provide capital to producers and traders.

A secondary function of credit which has assumed so much importance today is to permit the exchange of commodities without the intervention of legal tender money or to economise the use of currency by substituting a cheap medium of exchange for a more expensive and less convenient one. It also fills the gap, which the insufficiency of currency to meet the demands of modern expanding trade and industry, creates in our industrial society. Moreover, by allowing payments to be deferred

till it is convenient to the borrower to make them, credit provides a valuable facility to the debtor It should also serve, in skillful hands as an instrument for promoting industry and economic progress in a country

Reasons for the use of credit and credit instruments By allowing credit judiciously to customers sales are pushed up and the margin of profits is widened But before granting credit, searching and detailed enquiries into the character of the borrower and his business are made

The seller of goods accepts a credit instrument from his customer in payment for his goods first because he has confidence in the person who has given it believing that when he demand the promised money he will surely get it and secondly because on the strength of such promises made to him, he can, in his own turn make similar promises to others in payment for the goods purchased by him

Further they facilitate and cheapen the cost of transmission of funds from one place to another

Incidental advantages of credit Credit enables governments to excavate a Panama Canal or to wage a global war of agression or self defence, or to construct a Grand Trunk Road, or a sky-scraper or a trans-continental railway line In short, things which could not have been accomplished without the possession of huge funds are made possible by an extensive and developed system of credit

Individuals too, are enabled by credit to surmount temporary financial difficulties Credit makes it possible for them to satisfy their wants pending the receipt of a sufficient income, to purchase a home before the entire purchase money is in hand, and to acquire education with borrowed funds

Credit enables brainy businessmen with very little money in their pockets to embark upon gigantic enterprises Thus credit makes it possible for national resources to be utilised more effectively

Moreover credit has helped the growth of large scale production and of specialisation in the present day industrial society, and has made it possible to vary the scale of production to suit changes in demand Without credit our industrial society could not have emerged from the medieval household economy and adopted the twentieth century capitalistic system of production

Credit mobilises wealth lying in small quantities in the possession of a large number of persons to form a large mass of

capital which by being employed productively increases the material means of enjoyment in a country.

A careful control and regulation of credit minimises price fluctuations and leads to stablity in trade and industry.

Credit has helped invention, progress, development and industry. The great gain accruing from the use of credit cannot be over estimated. A great economist has aptly remarked that credit has done more to enrich nations than all the gold mines of the world put together.

Dangers of credit—Though the advantages of credit are many, yet it has latent dangers which cannot be ignored.

History furnishes numerous instances to show that credit is liable at times to be over-issued. In many parts of the world people have today become painfully aware of the evil consequences which flow from an over-issue of notes, resulting in inflation and abnormal rise in the cost of living. Similarly, an over-issue of loans encourages excessive speculation and results ultimately in over-production.

At times an enormous superstructure of credit is, in periods of optimism, built upon a dangerously slender foundation of cash. A slight adverse breeze may then become quite sufficient to pull down this weak superstructure and plunge the whole community in a financial crisis and subsequent depression.

Credit facilities available in a community may sometimes enable an inefficient entrepreneur to continue, with the help of borrowed funds, a losing business long enough to precipitate ultimately a big crash which may prove ruinous to a large number of persons. His limited personal resources could never have allowed his inefficiency to have so great a scope for inflicting financial losses on others.

The extensive system of credit which pervades the modern industrial society makes possible the procurement and control of so much capital by a person that competition is killed and a monopolistic control over the industry is ultimately established with the result that labour is exploited and consumers are fleeced by being charged abnormally high prices.

Easy credit has permitted States and individuals to indulge in wasteful expenditure which characterises the economic life of every land today.

Kinds of credit—If we focussed our attention on the borrower, credit may be divided into six classes.

(1) Public credit. It denotes the confidence which people have in the ability and willingness of a public body to redeem its financial obligations In other words it means the borrowing capacity of a public body as is reflected by the amount of loan it can get and the rate of interest it has to pay It embraces all borrowing operations of governments (central, provincial and local) or their promises to pay in the future in return for goods acquired in the present. As their current incomes cannot suffice for the construction of a Sarda Canal or a Shikarpur-Ballia railway line, loans have to be floated in the shape of interest bearing bonds and securities. Their sale at a discount denotes, generally speaking, a fall in public credit. Some writers use this term to signify the general credit of individuals in a nation

(2) Industrial or corporation or capital credit provides producers fixed capital for their industrial operations. In our society it appears in the shape of bonds or stocks or long-term loans which provides funds for starting or developing industrial ventures

(3) Mercantile or commercial credit is used by producers, wholesalers, retailers and commission agents etc. to provide themselves with the working capital which they require for the manufacture or movement of goods from the original producer to the ultimate consumer. It manifests itself as short-term loans which are raised by means of commercial promissory notes and bills of exchange.

(4) Agricultural Credit is employed by agriculturists to provide themselves with fixed capital for long periods and working capital for short periods of time

(5) Personal, individual, consumption, retail or book credit enables an individual to run up an account and procure consumption goods (without making an immediate cash payment) on the monthly bill system or the instalment plan The recognised earning capacity of the borrower forms the basis of such credit. No collateral security or written promise to pay is demanded from the borrower. In case the debtor defaults the creditor has the right to take back his goods

(6) Banking credit. In issuing bank notes and opening current and time accounts banks employ this kind of credit to borrow money from the public. Bankers' acceptances, letters of credit and debentures too belong to this category In other words, bank credit consists of simple debts due from banks. A customer makes his banker his debtor by transferring to

him his credits out of which he assigns to his creditors sums due to him from his banker. Such debts as are due from a bank to its customers and are intended to be transferred to the depositor's creditors by means of cheques are known as bank credits.

Yet another division—If we consider the uses to which the borrowed funds are put and the means by which the obligations thus created are to be met at maturity, credit may be again be divided into three classes. Investment credit, commercial credit and consumers' credit.

(1) Investment credit is used for the development and maintenance of industrial enterprises like railways, factories, workshops, farms, mines etc. It supplies fixed capital and is raised as long term loans through long dated paper.

(2) Commercial credit provides working capital to producers and traders for financing the production and marketing of goods. It takes the shape of short term loans and is raised by means of promissory notes and bills of exchange.

(3) Consumption credit is used by individuals to provide them with consumption goods. It is based on the size and sources of the borrower's income.

Merchantile or commercial credit and capital or investment or industrial credit—The distinction between these two kinds of credit rests on the uses to which the borrowed capital is put and on the time which intervenes between borrowing and repaying. Commercial credit gives working capital for obtaining labour supplies and materials needed for producing and marketing goods whereas industrial credit gives fixed capital for building factories and equipping them with machines, plants, building etc.

Commercial credit takes the shape of short term loans whereas industrial credit manifests itself in the form of long term loans.

Factors influencing volume of credit in a country —Trade and industrial conditions at home and abroad influence the volume of credit available in a country in a large measure. Brisk trade and industrial activity create a feeling of optimism and make credit abundant, but when business activity is depressed, credit also contracts. Wars and expectations of wars too contract credit. Similar is the effect of a public announcement of the intention of the existing government to inflate the currency. Political changes too disturb the volume of credit in a country. Expect-

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ations of assumption of power by a party whose election manifesto promises a capital levy are sure to curtail credit

Speculation increases the demand for credit and leads to its extension to a certain limit but it is also in its turn, influenced by the availability of credit in the community

The state of the country's currency is an important determinant of the volume of credit available in it If a country's currency is sound enough to infuse confidence in the public mind in its stability and to allow bankers to maintain a low ratio of cash to their deposit liabilities credit will expand If otherwise contraction of credit may reasonably be expected Movement of gold to or from a country also affects the availability of credit so long as an effective gold standard is functioning in the country With an inflow of gold the gold holding of the central bank improves, the bank rate is lowered and the credit expands An out flow of gold produces the reverse effect of contracting credit in the country

Factors influencing development of credit Business morality has exercised an important influence on the development of credit in the world If on demand the creditor is able to receive prompt payment and has not to take the help of a court of law for the enforcing of his claim trust is engendered and credit flourishes Trust makes the written promise of a stranger as good as gold and attracts goods from one corner of the globe to another without insistence on payment to accompany the transference of their possessions

A stable standard for deferred payments has also been a powerful factor which has influenced the development of credit and made creditor postpone the demands for repayment Moreover the growing security of private property and evolution of the legal system so designed as to fully safeguard individual rights and to enforce a prompt fulfilment of contracts, have been potent factors working in the same direction

Credit Instruments

To us in India credit has been known from times immemorial In ancient India, the word of the people was as good as their bond Hence credit instruments appeared in India long after people had become familiar with the uses of credit We have definite proof that these instruments existed in a developed form among ancient Greeks and Romans and Babylonians In U S A credit instruments account for the transactions of nearly 50 to 60 per cent of retail trade and over 90 per cent of the wholesale trade At present a great part of credit is evidenced by mere entries in account books and is known

as book credit. A sale on credit by a shopkeeper or a loan granted by a banker may be evidenced simply by an entry in the books of the shopkeeper or of the banker and may have no written promise signed by the borrower to prove it. Even then the shopkeeper or the banker has as good a right of action and the borrower has as legal a liability to pay as if he had executed a written document. All over the world credit is transferred by book entries without impairing in the least the legal or moral obligation of the debtor to pay. Such transfers are most common in the clearing houses and stock exchanges. Bonds and debentures too are used by individuals and joint stock companies for obtaining considerable amount of capital. But as all of them (except debentures to bearer) lack negotiability and are generally not acceptable substitutes for money, we shall defer their study to a later stage. (By negotiability is meant the quality of a credit instrument because of which it can be transferred to another person in such a way that the transferee becomes the legal holder thereof and vested with all the rights of the original holder. Its bonafide purchaser for value without notice of defect in its title comes to possess a better title to it than the original holder of the instrument with a flaw in it. In this respect credit instruments differ from other commodities and resemble money. An innocent person honestly receiving coins, notes, bills and cheques from a thief acquires legally a perfect title to them. Bills and cheques are divested of this quality by writing the word "not negotiable" accross their face. It is because of this characteristic of negotiability possessed by commercial credit instruments that they serve as means of payment and substitutes for money.) Instruments of credit in India are governed by the Negotiable Instruments Act of India. According to this Act, a negotiable instrument is a written instrument or evidence of debt which may be transferred by one person to another by endorsement or delivery so that the legal title to it becomes vested in the transferee.

(Endorsement means the assignment of the sum due under the credit instrument by the payee to a new payee by writing and signing on the back of the instrument a direction to pay to the latter. If the payee endorses an instrument with his signature without naming another payee, it becomes payable to bearer.)

Essentials of a negotiable instrument. A negotiable instrument must be (*a*) in writing, (*b*) properly signed, (*c*) negotiable in form (i.e. payable to order or bearer), (*d*) payable in legal tender,

A promissory note is an unconditional written promise by X (the maker) to pay either on demand or on a definite future date a specific sum of money to Y (the payee) or to Y's order or to bearer. It may not contain the name of the place of payment. It may be issued by individuals, institutions or governments. There are always two parties to a promissory note : (*a*) the maker or the person who promises to pay and (*b*) the payee or the person to whom payment has to be made. If the payee is the bearer of the note, the debt due under it can be transferred by simple delivery of the note to the person whom payment may be desired to be made. If, in a note, after the payee's name the words "or order" occur, the payee is granted the right to transfer his claim to another person by naming him, and writing a direction to that effect, and then signing his name on the back of the note. Thus the note has been endorsed by the payee in favour of another person who becomes the new payee entitled to receive payment of the sum due under the note. Promissory notes of banks payable to bearer on demand are called bank notes. Promissory notes issued by governments and central banks are declared legal tender and thus become money. In some cases the legal tender notes of central banks and governments are not in the form of promissory notes but state simply the amount for which they are to serve as means of payment. A note under which only one person is responsible for payment is known as a single *name paper whereas a note with two or three signatures or* makers is called a double-name or three-name paper. All promissory notes (except bank notes and currency notes) have to be drawn on properly stamped paper.

Rs. 500/- Allahabad. December 1, 1948.

Stamp.

Three months after date I promise to pay Shri Ghonchooji or order the sum of Rupees five hundred only for value received.

Bhondumal.

A bill of exchange is an unconditionally written order, signed by a creditor X (the drawer) ordering his debtor Z (the drawee) to pay, either on demand or at a definite future date, a specified sum of money to Y (the payee) or to Y's order or to bearer. The drawee may indicate his willingness to honour it by signing his name under the word 'accepted' written across the face of the bill. The sum due under an accepted bill is a legal liability of the acceptor, guaranteed by the drawer

and also by the intermediate holders who have endorsed it. Such a bill is readily discounted by banks. Generally a bill of exchange has three parties to it—the drawer, the drawee and the payee but when the payee is the same person as the drawer, it has only two parties to it. The seller of goods who draws a bill on the buyer makes it payable to his own banker who will arrange to have the bill accepted by the buyer and paid by him on maturity (or get the sum due under the bill "collected" from the debtor). The seller need not wait till the time of collection of the bill to receive his money. If he has created sufficient confidence in his banker he may get the bill discounted by his bank and receive its present worth. In discounting the bill the banker has in effect lent the amount of its present worth to the seller.

Bills of exchange belong to two broad classes: (1) Sight or demand bills which are payable on demand like our *Darshani hundies* and time or usance bills which are payable after a specified period of time like our *muddati hundies*. (According to D. I. C. Jain *hundies* may sometimes be conditional orders to pay and may, therefore, differ in this respect from bills of exchange.) Bills of exchange may again be divided into (*a*) inland bills and (*b*) foreign bills.

Inland bills are those that are drawn or made in India and made payable in, or drawn upon, any person resident therein. Other bills that do not answer this description are termed as foreign bills.

Specimen of an internal bill of exchange

Stamp Rs 1000	Allahabad December 2, 1948

Two months after sight, pay to the Editor of the Leader or order the sum of rupees one thousand for value received.

Ram Nath Ghose

To

The Editor,
The Pioneer,
Lucknow.

Specimen of a foreign bill of exchange

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100 dollars. Allahabad,
December 2, 1948

Two months after sight of this first of exchange (second and third remaining unpaid) pay to Mr. J. J. Thompson or order one hundred dollars for value received and place the same to account as advised.

To

Clark Warburton,
Philadelphia. E. V. Joseph

Foreign bills are a great help to traders. They save all the trouble, expense and time which are involved in shipping specie from one country to another. In the above specimen an Allahabad creditor has ordered his debtor in Philadelphia (U. S. A.) to make payment to his American creditor Mr. J. J. Thompson. In this way cross-shipment of funds between India and U. S. A. has been avoided. If the Indian creditor has no debt to discharge in America he may sell his bill to another Indian who has to make payment in U. S. A. Suppose Lala Ram Narain Lal has to pay 100 dollars to the Macmillan Co. of New York. He will then purchase this bill from Mr. E. V. Joseph of Allahabad and send it to his creditor—the Macmillan Co. of New York who will realise this amount from Mr. Clark Warburton of Philadelphia. In this way accounts have been cleared off without the transmission of actual money from either country. In international trade between two countries, mutual indebtednesses are offset against each other and it is only the balance that has to be liquidated by shipment of specie or bullion.

Bankers' or finance bills, commercial or trade bills or trade drafts or trade acceptances, and accommodation bills are a few other well-known types of bills.

Bankers' or finance bills are used merely as a means of making payments and transferring balances and are secured by the reputation of the bank that draws them.

A commercial or trade bill or trade draft or trade acceptance arises out of an actual sale of goods and is secured not only by the general responsibility of the drawer, but also by the bill of lading or warehouse receipt representing the goods which have been exchanged for the purpose of sale. It is an order drawn by a seller of goods against the buyer of those

goods and accepted by the latter Documents of title accompanying a bill serve as collateral security and provide additional security for the debt

Accommodation bills or drafts are those bills which do not arise out of any business transaction already concluded, though there may be an intention to purchase goods with the funds thus procured Such bills are generally drawn, accepted and endorsed without any value having been given

Cheques A cheque is a depositor's order to his bank to pay on demand a specified sum of money to himself or to another person or to his nominee or to the bearer of the cheque Thus a cheque is simply a demand bill of exchange drawn by a depositor on his bank Depositors in the current account and in some bank in the Saving Bank account too) enjoy this right of drawing cheques on their banks A cheque has also the same three parties as a bill of exchange namely, the drawer, the drawee and the payee Cheques may be bearer cheques or order cheques and may be crossed or uncrossed negotiable or not negotiable

A bearer cheque, as the name implies, is made payable to the person who presents it for encashment to the bank on which it has been drawn The paying bank is under no legal obligation to ensure that payment is made to the very person whom the drawer wanted to pay A chance finder of such a cheque may encash it still the paying bank will not be held responsible for making a wrong payment It does not need any endorsement for its valid transference

Specimen of a bearer cheque

No C 6543

Allahabad May 16, 1948

Imperial Bank of India,
Allahabad

Pay to Mr Raghunath Prasad or bearer rupees five thousand only

Rs 5000/-

Ram Dulare

An order cheque is made payable to a certain person or order, i e , to another person in whose favour the payee endorses the cheque In the case of such a cheque the bank has to see that payment is made to the right person If through the bank's negligence, it is encashed by someone else, the bank

will be held liable to make good this loss. At the time of transferring it to another person, it is necessary to endorse it in favour of the person who is intended to receive payment under it.

A crossed cheque is one across the face of which two parallel lines with, or without, the words 'A/C' or "& Co" have been drawn. The drawee bank pays the amount of such a cheque only to a bank. Crossing is simply a device to make the transmission of cheques from one place or person to another reasonably safe and to minimise chances of wrong payment.

Bank Drafts—A bank draft is an order by a bank to its own branch or to another bank in or outside the country to pay certain sum of money to a specified person or to his order or to bearer. Like bills of exchange, drafts too may be inland foreign instruments. Bank drafts are used to minimise the cost of remitting funds to distant places.

Distinction between a bill of exchange, a cheque and a bank draft. Of a bill of exchange, both the drawer and the drawee are individuals, whereas if the drawer is an individual and the drawee is a bank, the instrument becomes a cheque. In case of a bank draft, both the drawer and the drawee are banks. The payee in each case may be either an individual or an institution.

Uses of commercial credit instruments. These credit instruments economise the use of metallic money and provide a very convenient medium of exchange. They enable payments to be deferred until it is convenient for the promisor to make them and consequently reduce his difficulty and hardship. They stimulate production by enabling producers to spend in anticipation of receiving the sale proceeds of their produce.

The system of payment by cheques is very safe and convenient. The counterfoils of the cheque-book serve as a record of various payments made by the holder of the cheque-book. Moreover, the system obviates the necessity of keeping large sums of money in one's home. The holder of the cheque book has, therefore, very little to fear from thieves. Cheques economise the use of legal tender money in a country—cheques enable payments to be made conveniently over long distances. They constitute also a convenient form in which payments may safely be received.

SPECIMEN OF A DARSHANI HUNDI.

Shri sidh Cawnpore shubhasthan shri patri bhai Ram Lal Har Narain jog likhi Pragjie Ram Nath Chandu Lal ki

Ram Ram banchana Age hundi kiti ek ap upar kia rupia 500 ankan panch sau ke nime do sau pachas ke doone poore dena Yahan rakha bhai Imperial Bank of India, Allahabad ale ke miti Kartik sudi teras se pahunche dam dhani jog bina tabta rupia bajar chalan hundi ki rit thekane lagaye dam chaukas kar dena miti Kuar sudi teras Samvat 1978

SPECIMEN OF A MUDDATTI HUNDI OR USANCE BILL

Sidh Shri Indore maha subh sutank bhai Ala Bakhsh Madho Lal likhe Unnao e Ram Bihari Lal ki Ram Ram banchna Apprancli hundi 1 rupia 2,500 ankre pachis sau jiska nima rupia sarhe barah sau ka duna pura athe rakha The Bank of Indore Limited pas miti Bhadwa sudi 8 se dinco sath pichhe name sah jog hundi chalan Kaldar dija, miti Bhadwa sudi 8 Samvat 1978

N B The statement of half the amount payable is inserted so as to make fraudulent alteration more difficult

Investment credit instruments These instruments are used for procuring fixed capital by industries They may be conveniently classed as (a) bonds and debentures, (b) stocks and shares, (c) short term notes and (d) stock holders' rights

Bonds and debentures are instruments by means of which joint stock companies and governments obtain long term loans These instruments represent debts and therefore their holders are creditors Bonds which are payable to bearer or transferable by endorsement are as much credit instruments as bills and notes Interest coupons attached to bonds are torn off when due and presented for encashment like cheques They are considered safer investments than stocks and shares but much of their safety depends on the terms of bonds and of the *trust deed* which secures or ought to secure them If the debtor does not regularly pay interest on them, trustees may with the help of a court of law, have the debtor's property seized and sold at 'lock, stock and barrel' Even though no such fear exists in the minds of governments and municipalities, they are always careful to honour their bonds because they know that if they played false to one set of creditors, they would find it extremely difficult to discover another Of course the position of the creditor of a rotten company or of an impecunious state can never be as safe as that of the share holder of a sound company Bonds and debentures carry a fixed rate of interest and even if a company earns fabulously high profits, bond holders get only their pound of flesh

(b) Stocks and shares represent the capital of a joint stock company and are placed on its liabilities side by a company. Although stock holders and share holders are proprietors of their company, yet purchasers of stocks or shares and bonds or debentures treat them alike as is evident from their question 'Shall I invest in bonds or stocks and shares'?

(c) Short-term notes are employed for raising fixed capital and usually run from one to five years. They are generally secured only by the income of the company. They are issued to meet temporary emergencies. In periods of tight money or of general uncertainty about the future of the industry, it is difficult to sell long-term bonds. At a more propitious moment they are converted into long term bonds. Now-a-days they are generally used to provide funds for a new construction, if the debt can be paid off in a short time. Their claim on the company's income ranks after that of bonds.

(e) Stock-holders' privileges to subscribe to a new issue of shares by a company in proportion to the amount of their existing holdings of shares are issued to them in the form of transferable instruments. These rights are bought and sold on the market at prices which roughly represent the difference between the issue of the new stock and its prospective market price.

has shown that only a small fraction (say 10 per cent) of these deposits is sought to be withdrawn at any time. The remaining portion of these deposits could, therefore, be lent out by them and an income earned by charging interest from borrowers at a rate higher than what they allow to their depositors. The lure of an additional income by way of interest is sufficient to tempt depositors to save as much as they can and to leave their savings on deposit with banks. This capacity of banks to lend the major portion of deposits received from their customers enables banks to 'create' money and thereby, influence the price level.

How do banks create money ? Banks create credit in two ways: first, by issuing notes, and second, by advancing loans to businessmen and creating deposits in their favour.

When a bank issues notes, it has to keep an adequate reserve against its liability created by the issue of these bank notes. As only a small fraction of the total note issue is likely to be presented for encashment in terms of legal tender (generally metallic) money the maintenance of a correspondingly small amount of legal tender (generally metallic) by the issuing bank suffices to ensure the convertibility of its note issue. The remaining portion of the note issue that is not covered by a legal tender (generally metallic) reserve is protected by eligible securities which constitute the invested portion of the reserve. As long as the credit of the issuing bank is good, its notes circulate as money and serve as purchasing power in the hands of the public. This is the first way in which banks create credit money.

There is also a second way in which banks create credit money. When a bank accepts a deposit from a customer it has to pay interest to its depositor and incur some additional expenses on account keeping etc. Hence it cannot afford to keep idly with it all the money that it receives on deposit. Its own and other banks' past experience has taught it that a legal tender reserve of, say, 20% of its deposit liability is quite sufficient to meet the demands of its depositors for withdrawal of their deposits, and that the rest may be safely lent out. These sums lent out by the bank are again deposited (by persons to whom payments are made by borrowers) with this very bank or, may be other banks. 80% of these new deposits are again lent out In this way, a certain volume of cash reserve with banks suffices against a deposit liability to the extent of say five times its own volume.

Again, when a bank is satisfied that a borrower is credit worthy and is willing to offer collateral security acceptable to the bank, a loan is granted to him. The borrower, instead of

taking out cash may find it more convenient to leave the amount on deposit with the bank and to draw cheques against this deposit to his credit as and when, need arises. Receivers of these cheques may transfer them to others or deposit them in their account at the bank and draw cheques against these deposits. Since cheques serve as a medium of payment, banks create credit in this way by granting loans, overdrafts and cash credits and by purchasing securities. These cheques swell the volume of the circulating medium and influence the price level in the same way as successive issues of currency.

An idea of the extent to which banks can create credit may be formed by taking an example. In Britain the total deposits of the British banks about the year 1940 were estimated at about £2400 millions whereas the country's total stock of cash (i.e. other forms of money than bank deposits) could never have exceeded £ 600 millions and the total cash holding of British banks could certainly be not more than £250 millions. It is therefore apparent that the British banks had about the year 1940 created additional deposits to the extent of £2150 millions, otherwise, from where could this amount have come into their possession?

Functions of a bank. A modern bank performs numerous functions and renders varied services to the community. It is, by no means easy to catalogue, and consider, them all.

The primary function of a bank is to receive deposits from the public (at certain rates of interest) and thereby to mobilise the nation's savings to form a large stock of capital which, by being lent out to trade and industry (at higher rates of interest), stimulates production and makes it possible to raise the standard of living in the country. These deposits may be made either into a current account or into a fixed deposit account or into a savings bank account. A deposit in the current account may be withdrawn on demand (i.e., at any time) by drawing cheques against it. A bank does not usually allow any interest on such a deposit. Some banks allow it when for a certain length of time the deposit exceeds a certain minimum sum fixed by the bank. A deposit in the fixed deposit account, on the other hand, is not withdrawable on demand and before the expiry of the period for which it was made. A bank receives it subject to a timely previous notice of withdrawal mutually agreed upon between the depositor and the bank. Rates of interest allowed on these deposits vary with the length of the period for which money has been left on deposit with the bank. Deposits in the savings bank account carry interest but can be withdrawn only after satisfying certain

conditions. For example, some banks allow such deposits to be withdrawn only once a week, and require personal attendance of the depositor, or his agent, along with the pass-book at the time of withdrawal, or in case a large sum is sought to be withdrawn, a previous timely notice is insisted upon. These deposits are less liquid than deposits in the current account. Banks allow only a moderate rate of interest on deposits in the savings bank account.

An efficient discharge of this function by banks encourages people to save and place their savings on deposit with banks. In the absence of banks, people would have either spent away their entire incomes or hoarded their savings inside their homes. They could not have enjoyed the pleasure of seeing their bank balances swelling with every successive deposit and with the addition of interest to their accounts.

Deposit may be divided into (a) cash deposits (i.e. exchange of a right to draw cheques against customer's money deposit), and (b) credit deposits (or exchange of a right to draw cheques by the customer against a right to receive money by the bank). When a customer deposits coins, notes, cheques or drafts with a bank, a cash deposit is created, and for meeting its liability thus created by the customer, the bank has to maintain an adequate reserve to meet the demands for withdrawals. Credit deposits, on the other hand, are created by banks in favour of their customers by granting them loans, overdrafts and cash credits or by discounting their bills and promissory notes. Against these deposits customers draw cheques to pay off their other creditors.

The second function of a bank is to lend money. Driblets of spare cash collected from a large number of persons form ultimately a respectable volume of capital. Individual deposits may be withdrawn at any moment but deposits as a whole stay with the banker, suffering only slight variations from one date to another. The banker knows from his past experience what proportions of his deposits he can prudently lend with safety for varying periods of time. Comparatively speaking, although banks borrow in small amounts, yet they lend in large amounts, although they borrow for short periods , yet they lend for long periods; although they take in mobile wealth from their debtors as assets, yet they lend their *I O U* which are perfectly mobile and liquid and serve as money. By each one of these transformations the banker has increased the productivity of capital.

Bank's loans and advances take two principal forms. The first form is that of loan of a certain amount for a certain period

of time, or of an overdraft to a depositor in the current account up to a certain limit. Secondly they may take the shape of discounts. When a banker discounts a bill or a promissory note, what he does is to purchase the holder's right to receive payment in respect of that instrument on the date of its maturity. The banker pays the holder of the instrument its present worth (i.e. the face value minus the interest for the period that the instrument has still to run) and gets back his money on the date of maturity.

Loans belong to two broad cases of secured and unsecured loans. Secured loans are those that are covered by a depositor pledge of marketable stock exchanging securities, bullion, goods, bills of lading, warehouse receipts, land and buildings and documents of title thereto, and life insurance policies. On such loans bankers charge a lower rate than what they charge on loans against personal security alone, because if the borrower defaults or becomes bankrupt the loan can be realised from the sale proceeds of these collateral securities or if the banker needs money before the date of maturity he can repledge them with another bank and obtain a loan against them. Unsecured loans or clean advances may be made against the promissory note of the borrower (in which case it is known as a one name paper), or against the joint promissory note of the borrower and his guarantor or surety(in which case it is known as a two name paper).

Indian banks are extremely cautious in making unsecured advances but cash credits enjoy great popularity with them as well as with the borrowing Indian businessmen. These cash credits are loans against borrower's promissory notes, guaranteed by two sureties at least and often secured by a pledge of securities, goods etc. The lender can withdraw or reduce the accomodation whenever he likes, and the borrower has to pay intreset only on the amount for which the cash credit has been utilised.

Loans may again be divided into (a) time loans which are repayable generally after a period of a month or more, and (b) demand loans including call loans. In case of one type of demand loans, it is understood that the bank will allow the loan to run indefinitely unless the bank's deteriorating financial position necessitates its recall. These loans are, in actual practice, terminated only at the option of the borrower and carry usually a low rate of interest. Call loans or stock market loans are advanced generally to bill brokers and dealers on stock exchange and are terminable theoretically at a moment's notice from either the bank or the borrower, but in actual practice, on giving at least one day's prior notice.

Overdrafts are granted by the banks to their approved depositors in the current account. In case of overdrafts too, some banks demand a collateral security, especially if the amount of the overdrafts is a substantial one. According to the differences in the credit position of various customers, amounts and periods of overdraft allowed to them by a bank also vary.

In discounting a bill, a bank, in reality, gives to the holder of the bill a loan in the shape of the present worth of the bill, which he realises from the drawee on the date of its maturity along with the interest on this loan for the period that the bill had to run during its ownership by the bank. But banks prefer discounts to loans for several reasons. In the first place bills have a fixed date of maturity on which they have to be either paid or dishonoured, whereas loans seek frequent renewals. Secondly, as the date of maturity of bills is fixed and can neither be hastened nor postponed the discounting bank can know the condition of his assets correctly on any date that it chooses. In case of loans this facility does not exist for the lending bank. Thirdly, in case of discounting bills, banks enjoy the facility of readily re-discounting them and converting them into cash, whereas in case of loans, it is not equally easy to transfer them to another bank and receive payment in respect of them. Lastly the discounting of bills is considered to be safer than the granting of loans, because in case of bills, not only the drawee but also the drawer and all subsequent holders thereof are legally responsible for payment, whereas in case of a loan only the debtor and the guarantor or the surety can be proceeded against for its realisation.

Formerly the issue of notes was considered another main function of banks but at present it is only the central bank of a country that is generally authorised to issue notes. As long as commercial banks enjoyed the privilege of note issue, they had a very profitable business. They retained with them, for purposes of their business the money deposited by their customers and their creditors in terms of notes issued by them. In issuing notes a bank is in reality lending its credit and has to maintain a reserve varying in inverse proportion to its strength. The profit of the issuing bank equals the amount of interest on the difference between the values of its notes in circulation and the reserve maintained for the redemption of these notes. Of course some banks abused this right and failed ultimately, but notes issued by sound banks enjoying public confidence were willingly accepted by people for setting their mutual indebtednesses. This state of affairs continued in England till the year 1844 when the British Parliament had to pass the Bank Charter Act under

(g) Supply of suitable denominations and forms of currency to businessmen in different trade centres. For example, if businessmen in the interior parts of the country prefer to transact business in terms of coins and are disinclined to receive notes, banks working in those parts will try to supply specie in exchange for notes and thus facilitate trade.

(h) Transfer of superfluous funds from a place where they cannot be very usefully employed to another place where they are urgently needed and most welcome.

(i) Transaction of foreign exchange business including (i) the supply of foreign exchange to importers to enable them to supply foreign goods for home consumption and (ii) the discounting of bills drawn by exporters or foreign centres whereby exports of home products to foreign countries are facilitated. In this way banks help not only the internal trade but also the foreign trade of a country. In India, specialised institutions known as Exchange banks handle the work of financing the foreign trade of the country.

Apart from these services, banks also act as agents for their customers on whose behalf they perform such services as :

(a) The collections and payment of cheques, bills and promissory notes.

(b) The making of regular periodical payments to income tax department, insurance companies, clubs and societies according to the standing instructions of customers.

(c) The collection of dividends on stocks and shares, and interest on bonds and debentures held by their customers.

(d) Purchase and sale of stock exchange securities.

(e) Serving as correspondents, agents or representatives of their customers and of other banks and financial agencies at home and abroad.

(f) Acting as a trustee, attorney or executor for their customers.

(g) Receiving of rents, pensions, income tax and insurance premia on behalf of their customers.

Classification of banks—The financial needs of the modern industrial society are so varied that a country requires many types of banks, each of which is supposed to specialise in, and

discharge, a particular kind of financial business. As economic conditions and financial requirements differ from one country to another, and as banking is a dynamic process, it is difficult to classify banks in a way that may at once satisfy scientific accuracy and accord to realities. Even a simple classification which is based on functional differences and wholly ignores the regional variations may not altogether conform to realities because the same bank may, in actual practice be found engaged in many types of banking business.

According to their functions, banks may be placed in various categories such as commercial banks, industrial banks, agricultural banks, mortgage banks, cooperative banks, savings banks, central banks, exchange banks and international banks.

Corresponding to the two main types of credit, commercial credit and industrial credit—there are two principal types of banks as well. They are called commercial banks and industrial banks. Every industry needs two kinds of capital, viz. working capital and fixed capital. Commercial banks borrow for short periods and are therefore very well fitted for lending too for short periods only, i.e. for supplying to a producer or wholesaler or retailer or commission agent working capital which is needed for the production, movement or stocking of goods, and which can be recovered within a short period from the sale proceeds of the commodity produced or stocked by the manufacturer or the businessman.

Commercial banks, as a rule, have a small capital, relatively to their deposits. Working on so slender a foundation of their own funds and having always to reckon with the possibility of a run on them, these banks prudently keep their assets as liquid as possible and avoid locking up their funds in supplying the fixed capital requirements of industry. Hence they do not generally engage themselves in the formation of new companies nor do they take that direct interest in a new venture (of which they may have even underwritten issues) as is necessary to ensure their success. In short, their main concern is to maintain under all circumstances the liquidity of the major portion of their assets and they cannot afford to allow the lure of even higher profits to sacrifice the liquidity of their assets.

Ordinary commercial banking business largely consists in the purchase of personal credit of businessmen and sale of banking credit to them by discounting their notes or creating in their favour deposits against which they may draw cheques

Investment or industrial banking, on the other hand, concerns itself mainly with the supply of the fixed capital requirements of industry for equipping them with durable forms of capital like machinery, premises, fittings and furniture. As most of the funds at the disposal of commercial banks are furnished by short term deposits , they cannot afford to lock up their money in granting long term loans to industry. As industrial banks determine the channels into which available supplies of capital are to flow, every country realises the important part they play in the industrial life of the community. Still, till recent years, even a country like Great Britain has had no industrial bank worth the name. No doubt, British commercial banks advanced a limited amount of loans for providing farmers, householders and industrialists with such illiquid assets as farms, houses and extensions to the industrial plant. But the amount of help received from commercial banks was necessarily limited. Hence in November 1919, the Bank of England had to start the Securities Management Trust Ltd. to take off its shoulders the duty of assisting basic industries like steel and cotton industries and the industrial reorganisation of the country. The directors of this subsidiary company were chosen from amongst well-known experts fully equipped with the requisite technical knowledge so that they could assist any industry which wanted to rationalise itself. Again, on April 15, 1930, the Bank of England with the help of other principal banks floated the Bankers' Industrial Development Company Ltd. to deal with industry as a whole or a regional section thereof, not with individual companies. This company, probably in deference to the criticism of the Macmillan Committee, had later on to reduce itself to a skeleton by reducing its capital from £ 6 millions to £ 6000. During the last war Defence Regulations and Capital Issues Advisory Committee enabled the State to canalise national savings into war industries and government loans. In post-war years the national demand for an organised agency for industrial finance resulted in the starting of the Finance Corporation for Industry in January 1945, with an authorised capital of £ 25 millions. It has rendered substantial help to British industries by advancing loans and subscribing to their capital issues.

To help the financing of industrial reconstruction, the British Government had to start at the end of the last war another specialised institution, viz., the Industrial and Commercial Finance Corporation. This institution fills the considerable "credit gap" which cannot be filled by other banks and financial agencies in the country.

Following the example of Britain, India too had, for a long time no industrial bank worth the name Still the long term financial needs of industries were met, though inadequately by certain agencies In the wake of the Swadeshi Movement of 1905, a number of banks cropped up, specially in the Punjab to supply long term loans to industries, but they could not survive the banking crisis of 1913 16 After the first world war a number of industrial banks again came into existence but very soon they either disappeared or changed their business It is only recently that the bill for the establishment of an Industrial Finance Corporation has been passed by the Indian Legislature It is hoped that the assistance and advice of this Corporation will facilitate industrial expansion in this country on a large scale within a short time

In Japan however as early as 1902 the Industrial Bank of Japan came into existence to finance the Japanese industries Its success can no doubt be called creditable

Industrial banks, as a rule start with a large share capital and may further be empowered to raise additional funds to a certain extent by issuing long term bonds and accepting long term deposits They hardly receive any short term deposits hence they can afford to lend freely to industries for long periods Being share holders banks they try to invest their money where they expect to earn highest profits consistent with the assumption of the least amount of risk They do not care so much for the liquidity of their investments With stock exchanges functioning in important cities at present the danger of their investments remaining altogether illiquid largely disappears Hence, their distinctive guiding principles in the matter of investment differentiate them from each other Commercial banks always look to the liquidity of their assets, whereas industrial banks have their eyes mainly on the profit ability of their investments

Some countries have evolved another system, popularly known as mixed banking For example, German banks having a large share capital and existing mainly for financing the fixed capital requirements of industries, have by accepting deposits from the public embarked upon commercial banking as a sideline not as their principal business Similarly, in the U S A, commercial banks also undertake investment banking although the Banking Act of 1933 has done much to limit this admixture in their functions

Like manufacturing industries agriculture too needs working capital and fixed capital Just as industrialists have com-

mercial banks to provide them with short-term loans, similarly agriculturists have their cooperative banks to supply their needs for short-term loans in many countries. No doubt in some countries like the U. S. A. and Canada, commercial banks supply short-term loans to farmers as well. Long-term financial needs of agriculturists for buying farms, cattle and machinery and for sinking wells are supplied by the land mortgage banks or farm mortgage banks. In India the indigenous bankers still play a prominent part in supplying the credit needs of agriculturists all over the country, although their methods of business are not altogether straight.

Another type of banks commonly known as savings banks stand midway between commercial banks and industrial banks. Like commercial banks they too attract deposits from the poorer sections of the population but impose certain restrictions on withdrawals by depositors. Some of these banks permit withdrawal by means of cheques too. Like investment banks, they do not lend directly to individuals but buy investments.

A special type of commercial banks that have specialised in foreign exchange business in order to finance the foreign trade of India, and have their head offices in foreign countries is popularly known as exchange banks. Like other Indian joint-stock banks, they receive current, fixed and savings bank deposits and finance inland trade specially in goods in transit before leaving the country or immediately after entering Indian borders. But unlike other Indian commercial banks, they deal in foreign bills, grant loans against bills of lading etc., and finance imports of bullion into India.

Central Banks

Practically every country today possesses a central bank "which constitutes the apex of the monetary and banking structure of its country," and which is run not for earning the maximum profit for itself but for maintaining the general economic stability of the country and for carrying out the broad monetary policy of the state. Although its organisation resembles that of a joint stock bank, yet its purpose is altogether different from that of other banks. It is held responsible for regulating and controlling the currency and credit in its country so as to maintain the stability of the internal as well as the external value of the home currency. It has also to serve as the Banker's Bank and State Banker, and to provide clearing house facilities in the country. Its duties, therefore, include (*a*) the mo-

central banks as their financial agents. At present central banks (1) issue and repay their governments' short-term and long-term loans, (2) hold and disburse state funds, (3) undertake the safe custody of government's cash balances and (4) manage the public debt. During the world war, rather than wait for the successful floatation of a loan in the market, the state would obtain the necessary funds directly from the central bank. Even after the floatation of a huge loan, the central bank had to support the market by lending extensively. In both cases the central bank had to carry a huge portfolio of resulting obligations. Even the recommendations of the Cinliffe Committee could not materially relieve the Bank of England of this obligation. Other countries too have ordained their central banks to support the money market and the state and to finance the governmental short term loans which, by seeking constant renewal, have, in reality, become long term loans to the government. The Bank of France has been made legally and openly to grant huge 'permanent interest-free loans' to the French government. Dealings in government loans are now considered suitable for effecting necessary expansion and contraction of currency in the interest of price stabilisation. Further, a central bank is also considered to be capable of influencing the money market in such a way as to enable the state to raise its loans at a lower rate of interest and thus save the tax-payer from the burden of heavier taxation.

Unfortunate experiences of several central banks about the financing of the state during the first world war were responsible for imposing severe restrictions on their powers of making advances to the state or buying government securities in the post-war period.

Central banks' relations with the state during the last hundred years reveal an alternating loose control and tight grip of the state over the central bank. Till the seventies of the last century various governments pressed their central banks for increasing accommodation, but, with the wide-spread adoption of the gold standard, central banks were allowed to enjoy a freer atmosphere till the outbreak of the first world war. From 1914 onwards central banks were again yoked in the service of the state for bringing the war to a successful termination. The seven years preceding the onset of the great depression were again marked by the comparative freedom of central banks from state domination. Suspension of the gold standard in 1931 and outbreak of the second world war in 1939 reversed the process and increased the control of the state over

be elastic also. Hence various methods have been evolved for regulating the volume of note-issues in a country.

The first system of note-issue adopted in 1844 by England and later on by several other countries is known as the partial fiduciary issue method. Under this system, the Bank of England was authorised to issue notes up to a fixed amount against government securities kept by it in the reserve, but all notes issued above this amount had to be fully covered by gold. In September 1939, this system was discarded and now the note-issue of the Bank of England is directly covered mostly by government securities and only a small amount (about £ 1,500,000) of gold and silver coins is in the reserve. (At present all the gold and foreign exchange reserves of Great Britain are concentrated in the Exchange Equalisation Account).

The second method of a fixed maximum issue (which may be raised from time to time) without any gold cover being prescribed by law has been followed by England since 1939 and by Japan since 1941. France too followed it between 1870 and 1928. At times this system was found to be rigid and inelastic, and at times it led to inflation.

The third method limits the note-issue to the value of eligible government bonds held in the reserve and the paid-up capital of the issuing bank. For some time this method was followed by the Colony of the Cape of Good Hope in South Africa where the note-issue was limited to the paid-up capital and reserve of the issuing bank and had to be fully covered by government securities. This system suffers from inelasticity.

The fourth method is known as the proportional reserve system under which the issuing bank is required to maintain a metallic and foreign exchange reserve of at least 25 to 40 per cent of its note-issue and the remaining portion has to be covered by certain specified assets. This method has been widely adopted, with slight variations, by Germany, U. S. A., India and other countries. This system possesses elasticity.

The fifth method used in the Union of South Africa since 1930 prescribes a gold reserve to cover at least a minimum percentage of the note-issue, but makes the notes a first charge on all the assets of the issuing bank which is, thus, allowed greater freedom in the selection of its assets which may be used as a cover for that portion of the note-issue which is not covered by gold. This system combines maximum elasticity with adequate safety for the country's note-issue.

demands of its customers for accomodation of which they are assured by the preparedness of the central bank to rediscount their bills apparently without limit. But as the central bank has to conserve the supply of credit and protect its gold reserves from suffering a dangerous depletion, it has sometimes to raise its discount rate so that the demand for accomodation may remain confined to those cases alone which are most urgent and necessary.

In a well-organised money market a close relationship between the bank rate and short-term money rates tends to be established, if the money market works on a narrow margin and depends upon the central bank for ultimate accomodation in times of need. This relationship is strengthened by traditions, conventions and acceptance of the leadership of the central bank. In times of heavy seasonal demand or increased business activity the money market has to approach the central bank for rediscounts and for obtaining its supplies of loanable funds. When a bank obtains its supplies of funds from the central bank at the Bank rate, it cannot afford to charge its customers any rate lower than the Bank rate. In this way the market rate of discount is forced up to the level of the Bank rate which becomes effective in curtailing credit. Ordinarily, the central bank is able to contract credit by raising its discount rate, but, at times when the money market has sufficient funds and consequently no need to seek accomodation from the central bank, it has to resort to open market operations in order to deplete the market of its funds and 'to force' it into borrowing from the central bank which, then, charges its official discount rate and makes it effective.

If at any time, the central bank desires credit-expansion, it lowers its discount rate and expects the money market to follow its lead and lower the market rate of discount too. If the central bank is not obeyed by the money market, it announces its willingness to have direct dealings with (by discounting bills directly for) the general market. In competition with the central bank, the money market has ultimately to lower the market rate of discount and allow credit expansion.

In short, the rediscount rate is the principal instrument by which the central bank encourages or discourages rediscounting with it by member banks. By raising its rediscount rate, the central bank makes borrowing by its member banks more expensive, and thus restrains them from expanding credit. By lowering its rediscount rate the central bank makes borrowing by member banks cheaper, and thus encourages banks to

extend credit The extent to which a central bank can make its discount rate effective depends on certain conditions, If, for example, the price-level is rapidly rising, the raising of the discount rate may prove ineffectual to a great extent, as central banks of Europe found it to be after the first world war. If other banks possess greater resources than the central bank, they combine to neutralise greatly the efforts of the central bank to restrict credit in the market.

Open market operations—If member banks possess sufficient funds of their own, the central bank's discount rate may prove powerless to restrict credit and raise money rates generally. For the purpose of controlling the money market a central bank is, therefore, provided with another powerful weapon known as open market operations.

Meaning of open market operations—Open market operations mean the central bank's purchase or sale of any kind of eligible assets (such as stock exchange securities , bankers' acceptances or foreign exchange) for the purpose of controlling credit in the country.

If the raising of the discount rate in order to restrict credit proves insufficient to raise the money rates in the market, the central bank begins to sell securities or bills in the market and thereby draw money into its coffers till the cash position of member banks is so much weakened that they have to seek accomodation from the central bank. The central bank then charges its official rate of discount which thus becomes effective.

Similarly, in order to relieve a sudden stringency in the money market, a central bank may resort to direct dealings with the money market, when in competition with the central bank other banks will have to lower their own rates. Alternatively , it may start purchasing bills and securities till the cash holding of member banks is greatly inflated. As they cannot afford to keep idly with them large amounts of cash, they try to attract their borrowers by offering lower discount rates. In this way , the central bank's lowered Bank rate becomes effective The same end of making the Bank rate effective is achieved by the central bank by the purchase or sale of

(1) the short term loans of the government (or treasury bills),

(2) long-term loans of the government,

(3) foreign exchange,

(4) stock exchange securities,

(5) banker's acceptances,

(6) precious metals, and

(7) by borrowing or repayment of loans in the market against the pledge of government securities.

Open market operations, in this way, increase or decrease the supplies of loanable funds in the market and thus force an expansion or contraction of credit in the country.

It will be thus seen that the credit policy of the central bank finds expression through its effect on the cash position and the lending capacity of member banks. Ordinarily, it is not necessary to use these powerful weapons in actual practice. The mere fact that the central bank is armed with them is sufficient to ensure the member bank's ready submission to the wishes of the central bank in this matter.

Scope of operations of central banks.—Should a central bank act as a relief institution only in an emergency or serve as a constant equilibriating factor in the money market ?

Believers in the emergency relief theory hold that a central bank exists solely for meeting emergencies and that in a crisis alone it should come out "like a fire engine" to put out a financial conflagration. On the other hand, exponents of the banking point of view hold that a central bank should function continuously and regularly like any other bank (and unlike a relief institution) and that it should formulate suitable policies for every occassion and handle emergent situations as they arise. This divergence between the opinions of these two schools has also created a difference in the extent to which a central bank should have the right to embark upon open market operations. During discussions on the Federal Reserve Bill, American banks strongly opposed the grant of power to Federal Reserve Banks to operate in the open market but during recent years both Europe and America have admitted that a continuous and liberal use of these operations is necessary for central banks. If member banks confined their credit extension within proper limits, a central bank can have no legitimate occasion to interfere, but, as government transactions, international banking operations and speculative outbursts are constantly disturbing the market, the central bank has to remain practically all the time in the market as a constant factor.

CHAPTER XXXXV

EXCHANGE AND INTERNATIONAL BANKS

The business of mobilising and transferring funds from a country where capital is cheap to another country where it is dear is known as international banking. This transference of funds between two countries may also be necessitated by the need for the settlement of current international obligations. Again, the transference of funds may be for a short term as in the case of acceptance credit or it may be for a long term consequent on a bond issue. Success in both fields depends on a bank's ability to establish respectable foreign connections.

European merchants of the 16th century like the Fuggers of Augsburg appear to have been the pioneers in international banking having undertaken the financing of foreign trade as well as the granting of long term loans specially to royal borrowers. The banking house of the Fuggers helped Charles I King of Spain and Sovereign of America to become Emperor Charles V of Germany in 1519, and in return, got the right to transact the entire banking business of his vast empire and the monopoly of coinage and of working a number of mines in Spain and America. Their fabulous wealth enabled them to become bishops, barons, dukes and even princes and to survive even to this day. Coming to the 18th century we find London banking houses undertaking international acceptance business floatation of foreign government loans and sale of foreign industrial securities. The best known among them—Barings and Rothschilds—granted extensive short term credits to foreigners and also raised long term loans for them. After 1914 New York captured the field of international banking and floated successfully many loans for the Allied Powers. After 1918 large credits were extended to Germany and Latin America too but their numerous defaults ultimately closed the doors of this market to defaulted foreign borrowers. Soon after the first world war new American banking companies began receiving foreign deposits issuing acceptances and financing foreign trade. Practically since the beginning of the present century a plentiful supply of loanable funds in the U S A influenced New York to undertake international banking. No doubt, besides London and New York some other centres like

Paris and Amsterdam too took an appreciable part in international banking.

Recent political and economic factors have undoubtedly paralysed long term international credits and short term international trade finance, but international deposit banking specially in the U. S. A. has been recently greatly stimulated. Whereas formerly liquid funds would seek markets where interest rates were high, during the interval between the last two world wars their movement was influenced by speculative forecast of probable changes in foreign exchange rates, and was responsible for introducing a good deal of uncertainty in this field. Hence after 1929 many countries had to establish exchange equalisation accounts for stabilising exchange rates.

Since 1925 economic and financial interdependence of various countries necessitated the maintenance of close co-operation between various central banks. During a modern war, credit control and inter-government collaboration are necessary and in peace time too, international rediscounting and tranfers of gold have to be undertaken to prevent national or global crises. During the first world war such an international banking cooperation was attempted both by the Allied and Central Powers. In the post-war period too, the Brussels Conference of 1920, the Genoa Conference of 1922, the World Economic Conference of 1933, the Macmillan Committee and the Gold Delegation emphasised such a collaboration in the interests of the weakened central banks and for the prevention of the revival of the pre-war mad "scramble for gold". After 1924 leading central banks had to promise funds for safeguarding the normal functioning of the new currency standards adopted by various countries. The Federal Reserve Bank of New York promised to purchase British bills up to a certain amount at a fixed rate of discount, if need arose, to help the maintenance of a Gold Bullion Standard in Britain. The success of these experiments in the field of international financial collaboration paved the way for discussing the practicability of establishing a world adnk to deal with the problems of international stability of prices and control of money markets and of German reparations (imposeb by the Treaty of Versailles) and other connected issues. The Young Plan of 1929 which superseded the Dawes Scheme of 1924 embodied the recommendations of the reparations experts and originated, mainly for the purpose of dealing with the problem of German reparations, the Bank for International Settlements which was founded in 1930 at Basle under a Swiss charter under the official sponsorship of the central banks of

England, France, Germany, Belgium, Italy, and Japan and an American group of bankers with an authorised capital of five hundred millions Swiss gold francs According to its statutes, it was intended (1) "to promote the cooperation of central banks (2) to provide additional facilities for international financial operations and (3) to act as trustee or agent in regard to international financial settlements entrusted to it " But with Germany's default in paying reparations after 1931 disappeared the main purpose for which it was created Still its official status and potentialities as an international banking institution, rather than its intrinsic worth at the present time, are responsible for the attention that has to be bestowed on it Although it was intended to become a central bank for other central banks yet its relations with other leading central banks are reciprocal Its incorporating act limits its general banking business to (1) the acceptance of deposits from and acting as a discount agent for other central banks (2) dealing with other banks and individuals only with the express permission of the central bank of the country concerned, (3) the purchase and sale of gold and foreign exchange, (4) rediscount for central banks, etc It has no right of note issue and has to maintain a gold or foreign exchange reserve of 40 per cent against its demand liabilities and of 25 per cent against its time liabilites 'In the past the Bank confined itself to receiving and administering deposits expressed in a weight of fine gold At present the Bank has shortened the term of its investments and accumulated a substantial stock of gold for its own account, particularly in Switzerland and the United States" Assets like rediscountable bills and acceptances consisting of commercial bills, bankers' acceptances, and Treasury bills, sundry bills and investments and claims and the Bank's funds in Germany reveal the Bank's main activities these days Its liabilites include (1) deposits of central banks and other depositors, (2) international postal payment account and (3) German Government deposits, and throw light on the Bank's current activities It has also continued to discharge trustee and agency business

The success of the Bank may be judged from the facts (1) that it could float in June 1930 the first German annuity loan of three hundred million dollars, and (2) that it was made trustee for a new Austrian loan of a hundred million dollars Even though after 1931 Germany stopped paying reparations and practically every important country went off the gold standard yet the Bank has survived the last global war and the recent appearance of most powerful institutions like the International Monetary Fund and the International Bank for Reconstructio

and Development, in the field of international banking. These two institutions are largely complementary in character of membership as only members of the Fund can become members of the Bank.

The International Monetary Fund and the International Bank for Reconstruction and Development.

The establishment of these two international financial institutions, viz., the International Monetary Fund and the International Bank for Reconstruction and Development was recommended by the United Nations Monetary and Financial Conference held at Bretton Woods in July 1945.

The former has been set up (1) to promote international monetary cooperation and to provide a machinery for consultation and collaboration on international monetary problems; (2) to promote exchange stability, to maintain orderly exchange arrangements among members and to avoid competitive exchange depreciation; (3) to establish short term equilibrium in the international balances of payments; (4) to promote balanced growth of international trade of member countries without unduly restricting their freedom to pursue their own domestic social or political policies; (5) to assist (a) the establishment of a multilateral system of payments in respect of current transactions between members and (b) the elimination of foreign exchange restrictions which hamper the growth of world trade. Thus the Fund has been designed primarily to meet the short term credit needs of member countries. The Bank, on the other hand, is intended mainly to stimulate and, where necessary, to supplement the flow of international long-term capital for assisting the reconstruction and development of member countries with a view to attain long term international equilibrium.

The relative share of countries in the share capital, voting rights and managment of the two institutions and the borrowing rights in the Fund (but not in the Bank) are regulated by the quotas of members, the six largest quota-holders being the U.S.A., the United Kingdom, the U. S. S. R., China, France, and India.

The International Monetary Fund started functioning from March, 1947 and its first exchange transaction took place about the end of May, 1947, when the Fund granted stabilization credits to France and the Netherlands. By the end of May 1948 the Fund sold exchange against members' currencies for more than six hundred million dollars. Besides these sales against members' currencies, the Fund sold a small amount of U.S. dollars against

gold. To meet the growing deficit in her balance of payments with the United States, India purchased from the Fund nearly 44 million U. S. dollars till the end of June 1948 by tendering the equivalent of this amount in rupees. In June 1947 the Fund warned member countries against external sales of gold at prices above monetary parity and urged them to eliminate such transactions. In December 1947 the Fund directed its members to obtain its previous sanction before subsidising gold production. In obedience to this direction from the Fund, Canada placed its proposed scheme (for subsidising gold production) which was examined and approved by the Fund. In April 1948, the Fund advised its members participating in the European Recovery Programme to apply for the purchase of U. S. dollars only in case of exceptional or unforeseen hardship so that the resources of the Fund may be maintained at a safely high level.

The International Bank for Reconstruction and Development became active from May 1947 when it granted its first loan of 250 million dollars to France. Later, the Bank granted loans amounting to 263 million dollars to the Netherlands Denmark, Luxembourg, and Chile. These loans have been granted in U. S. dollars, Belgian francs and Swiss francs for the purpose of financing imports of capital goods and equipment necessary for the reconstruction and rehabilitation of vital sections of war ravaged European industries, and for the development of agriculture and hydro-electric projects in Chile. The Bank is, at present , examining some other applications for loans from its members.

In July 1947 the Bank's first issue of bonds totalling 250 million dollars was heavily over-subscribed in the U. S. A. The Bank's other floatation of bonds in the Swiss market in May 1948 was entirely taken up for investment by the Bank for International Settlements. Such productive loans as these are raised in a market, or granted to a country out of its own paid-up capital and general reserves only when the Bank is unable to promote foreign investment (on reasonable terms or in adequate amounts) by guaranteeing the whole or a part of the loans which may be made by private investors through the usual investment channels. Ordinarily, New York, London and other financial centres invest their surplus capital in certain classes of foreign loans and issues of securities at relatively low rates of interest, even without any guarantee from the Bank. The Bank's guarantee is needed only for such loans as are sound propositions but are still not being taken up by the market at all or can be floated only at high rates of interest. The Bank's guarantee is really

an international guarantee which spreads the risks of foreign loans over debtor as well as creditor countries. As such, the practice is likely to prevent the disequilibrium between international saving and international investment and to give each country a larger stake in the world as a whole. This measure is also calculated to swell the stream of loanable capital and to make it available at relatively low rates of interest, say 4 to $4\frac{1}{2}$ per cent per annum. In order to minimise the risks assumed by the Bank in guaranteeing or granting loans, the government or the central bank of the borrowing country has to guarantee fully the repayment of the loan and its attachment charges.

The Fund and Bank plans aim at securing a world economic cooperation of which central banking cooperation forms an important part. The Fund plan contains certain features of the gold standard such as, (1) gold as the common measure of values, (2) a fixed par value (in terms of gold) for the currency of every member country, (3) the confining of fluctuations in the exchange rates between currencies of member countries within a specified limit on either side of the par value for transactions in gold. It is a modified form of the gold standard because (1) its functioning does not entail the free convertibility of currencies into gold, (2) it permits its members to exercise the necessary exchange control over capital transfers, (3) it allows orderly charges in the par values of currencies in case of fundamental disequilibrium and for uniform proportionate changes in the par value of currencies generally. The Fund plan, therefore, removes the rigidity of the gold standard and makes it suited to serve the needs of a world suffering from disequilibrium, maladjustment and disruption caused by the two great wars of this century, and possessing managed currencies which occasionally display competitive depreciation with its attendant evils. No doubt, the deteriorating world economic and political conditions these days make the prospects of the success of both the Fund and Bank plans rather dark. Moreover, the financial requirements of the present world appear to be much more than what the resources of the Fund and the Bank can safely supply. These twins promise to replace narrow nationalism by broad internationalism but much of their success depends on whether they can sail quite clear of the Scylla and Charybd is of racial discrimination and power politics which are threatening at present to founder the ark of human civilisation.

PART IX

International Trade

CHAPTER XLVI

THEORY OF INTERNATIONAL TRADE

International trade refers to the exchange of goods and services between one country or region and another. This is to be distinguished from internal or domestic trade which deals with trade within the geographical boundaries of a nation.

Why do people engage in trade? For the simple reason that such an exchange increases their satisfaction by enabling the participants to share the advantages of the division of labour. Man has numerous wants, but he seldom can produce all the things he needs. He, therefore, specializes in producing things for which he is best fitted and exchanges his surplus for the things produced by others. Such a process of exchange enriches both the parties.

On the same principle, each nation tends to concentrate on the production of things for which it is most suited. Just as specialization benefits the individual, so also it benefits regions and countries. Nations differ in their natural resources, the skill and capacity of their workers, their geographical position etc. Accordingly, each nation is better equipped for taking to some special branch of production than every other. It is to the advantage of all to specialize in their respective spheres and exchange their output. In the words of Marshall, "If goods, which can be produced at home, are yet imported freely from abroad, that shows that they can be got generally, at less cost by making other things with which to buy them from abroad than by the direct method of making them at home."

If the justification for all trade, be it internal or international, lies in the advantages of division of labour, why should there be a separate theory for international trade? The answer is, that in spite of fundamental similarities, there are certain basic differences between the two which necessitate a separate theory for international trade.

Distinction between foreign trade and home trade. First, labour and capital are more mobile between different parts of the same nation than between different nations. The cause of this immobility is prejudice, differences in language and customs, natural inertia, restrictions placed by nations and so on. Generally speaking, the degree of immobility is greater for

labour, since it relates to the human factor But even though capital is comparatively more mobile it tends to congregate generally within national boundaries chiefly due to the greater risk and uncertainty of foreign investment Thus 'production in different countries is carried on in more or less closed or non competing compartments while production in any one country is accompanied by a direct competition for the several agents of production

Secondly all trade is carried on in terms of money But while in internal trade the same monetary unit is used in international trade two or more different units are used in one transaction The fact that trade between nations involves not only an exchange of goods but also an exchange of their moneys, raises problems of foreign payments rates of exchange, relative values of the monetary unit etc, which in practice exercise a great influence upon the direction and volume of trade

Lastly, each country conducts its production under different conditions regulations and systems There are differences in the systems of taxation of labour legislation, of social insurance of transport and public utility services of commercial and fiscal policy of industrial organization, etc A nation's economy is shaped by these factors, and consequently such differences have a marked bearing upon the course of international trade

Conditions leading to international trade On the basis of international division of labour it can safely be said that commodities tend to be produced in those countries where their cost of production is the lowest This explains why India produces jute oil seeds tea and similar goods which occupy a prominent place in its export trade Similarly, Japan produces and exports textiles and toys Great Britain manufactures and sends out woollen goods and tools U S A engages in the production of machines cars and numerous other manufactured products and has a foreign market for such wares

Absolute differences in cost In some of these cases the producing country has a definite superiority in what it produces and exports (coffee in Brazil, spices in the tropics, jute in India steel in the U S A, etc) and an equally definite inferiority in what it imports The condition which leads to trade along these lines is known as a condition of absolute differences in costs Let us illustrate such a case by taking two countries and two commodities and representing the costs in terms of labour (as the Classical economists did)

	Jute	Woollens	
England	1 unit	2 units	Product of one day's labour.
India	2 units	1 unit	

Clearly, England enjoys superiority (absolute advantage) in producing woolens and India in producing jute. Each nation will, therefore, specialize in the field where it reigns supreme, and engage in trade with the others. The advantage they gain thereby can be expessed in term of the increase of total produce. For if each nation meets its own requirements of both jute and woollens, the total product of 4 days' labour is 3 units of jute + 3 units of woollens.

But if there is specialization and trade, the total output for the same effort is 4 units of jute + 4 units of woollens.

Moreover, on the basis of labour-costs, the ratio of exchange between jute and woollens is as follows:-

England 1 unit of jute for 2 units of woollens

India 1 unit of jute for $\frac{1}{2}$ unit of woollens.

England gains by exporting woollens and getting anything more than 1 unit of jute for 2 units of woollens. Similarly India gains if she gets anything more than 1/2 units of woollens for 1 unit of jute. If we neglect transport costs and other complicating factors, and assume that the intensity of demand for these goods is such as to enable the countries to share the increase in production equally, the ratio of exchange at which trade is carried on will be :—

1 unit of jute for $1\frac{1}{4}$ units of woollens ;

a transaction advantageous to both.

Equal differences in costs. Let us take another example, on the same lines as before:-

	Textiles	Woollens	
England	2 units	2 units	Product of one day's labour.
India	1 unit	1 unit	

In this example, England has an absolute advantage over India in the production of both textiles and woollens i. e. labour is more efficient in both the industries in England. But the degree of superiority is the same in both cases. The ratio of exchange is as follows:—

England	1 unit of Textile for 1 unit of Cloth
India	1 unit of Textile for 1 unit of Cloth

Thus even with absolute superiority in both the fields of production, England does not gain anything by trading with India And, in spite of its inferiority in both, India does not lose by not trading with England This situation arises because the ratio of exchange is the same in both the countries In other words there is equal difference in costs As is obvious, no trade will ensue under these conditions

Comparative differences in costs The type of cheapness as represented under absolute advantage, does not explain the movements of goods between nations There are occasions (and the majority of foreign trade transactions come under this head) when a country is superior to another in the production of both commodities and yet it imports one of these A manufacturing country like U S A, imports tools and machinery of a certain category from Britain, even though it may be superior in the production of that A country like England, though better suited to the production of dairy products than Denmark, yet imports such goods from that country. What is the reason for such seemingly strange transactions? Undoubtedly, that such a flow of goods brings some gain to U S A, and England By concentrating on the production of certain manufactures, and exporting them, U S A can obtain certain types of tools and machines from Britain at a cheaper rate Similarly, England finds it to her advantage to import dairy goods from Denmark in return for machine made articles like textiles and cutlery etc In other words, through such transactions, the countries concerned obtain greater relative advantages

Similar is the case with the productive activities of individuals The same person may be an expert manager and an efficient clerk, yet he may find it to his advantage to devote his energies to the managerial task and assign the job of a clerk to another man less efficient than himself Such specialization is a common feature of modern industrial organization and the results prove the wisdom of the method Therefore, as Adam Smith said, 'What is prudence in the conduct of every private family, can scarce be folly in that of a great kingdom'

The condition determining such an exchange of goods is known as the principle of Comparative Costs. According to this, "Each country tends to produce, not necessarily what it can produce more cheaply than another country, but those

articles which it can produce at the greatest relative advantage, i.e., at the lowest comparative cost. Each country will produce those articles in the production of which its superiority is most marked or its inferiority least marked." In other words, those products are exported which are lower in price (calculated on the basis of the ruling rate of exchange) within the borders of a certain country than elsewhere, and those are imported which are higher in price at home than abroad.

A difference in the cost ratios is, then, the basis of international trade. What is the factor responsible for cost differences between nations ? It is Nature's partiality in distributing its gifts to nations. That is why India with its fertile soil, warm climate and cheap labour produces rice, jute, sugarcane, tea, etc., at comparatively lower costs and supplies these at low prices. Similarly, U. S. A. with its vast resources of coal, iron, petroleum, skilled labour, and capital, dominates the field of manufactures of various kinds. Its costs are low and so are its prices. The case of Japan (with its cheap skilled labour and mechanization) a formidable force in pre-war world trade, will further bear out that the form and strength of productive resources determine costs and prices of goods and create differences in the cost ratios between one country and another.

Illustration. Some assumptions will be made here in order to explain the working of the principle of Comparative Costs. We will take only two countries and only two commodities and also neglect the cost of transport. Further, costs will be represented in terms of labour costs, and it will be assumed that production is carried on under conditions of constant costs, i. e. the amount and volume of production does not affect the cost per unit.

Later on these assumptions will be removed and it will be shown that their removal does not affect the essentials of the theory.

Country	Rice	Linen	
A	3 Units	2 Units	Products of one day's labour.
B	1 Unit	1 Unit	

Country A is superior in the production of both rice and linen, but it has greater relative advantage in the production of rice. For in rice its superiority is three times that of country B, whereas in linen it is only twice that of B. Hence it has a

lower comparative cost in the production of rice and will specialise in this branch of production and through its exports obtain the required supplies of linen On the other hand, though country B is inferior in both the fields of production, its inferiority is less marked in linen (its comparative cost of linen is less) It will, therefore, specialise in the production of linen and through its export obtain the necessary supplies of rice.

The ratios of exchange between the two commodities in the two countries are :

Country A 1 unit of rice for 2/3 unit of linen.

Country B 1 unit of rice for 1 unit of linen.

Thus in B more linen can be had for the same amount of rice, i.e., linen is cheaper in B, in spite of its lower efficiency of labour. In A more rice can be had for linen, i.e., rice is cheaper. A would gain through trade as long as it procures more than 2/3 unit of linen in return for 1 unit of rice. B would gain if it gets more than 1 unit of rice in return for 1 unit of linen. In other words, both countries would gain, if A concentrated on the production of rice and exported it to B, leaving it to specialise in the production of linen and export it to A.

Moreover, it will be seen that such specialization increases total production. For, if both countries continue to produce the two commodities, the total product is 4 units of rice+3 units of linen, for 4 days' labour. On the other hand if A produces rice and B produces linen, the total product is 6 units of rice+2 units of linen. The gain of 2 units of rice is greater than the loss of 1 unit of linen (2 units of rice is equal to 4/3 units of linen in A and 2 units of linen in B). Specialization and trade have resulted in an increase of the total product.

It was on the basis of such considerations that Cairnes made the (oft quoted) statement : "The one condition at once essential to and also sufficient for, the existence of international trade, is a difference in the comparative, as, contradistinguished from the absolute cost of producing the commodities exchanged". The same idea was elaborated by Ricardo in his celebrated example : "Two men can both make shoes and hats, and one is superior to the other in both employments ; but in making hats he can only exceed his competitor by 1/5th or 20 per cent and in making shoes he can excel him by one third or 33 1/3 per cent. Will it not be for the interest of both that the superior man should employ himself exclusively in making shoes, and the inferior man in making hats?"

So we may conclude, that whether trade is due to absolute advantage or comparative advantage, it arises through the same fact, namely that the comparative costs of production and consequently the relative values of goods differ from country to country.

Introduction of Money-costs. In actual transactions, money cost is the determining factor. The above example needs to be modified in order to represent the cost of production in terms of money rather than labour.

	Rice	Linen	Wages per day	Cost per unit	
Country A	3 units	2 units	Rs. 2-8-0	Rs. .833	Rs. 1.25
Country B	1 unit	1 unit	Re. 1-0-0	Rs. 1.0	Re. 1.0

Rice is cheaper in A and linen in B, hence the direction of trade will be the same as determined before on the basis of comparative costs of production. Such a state of affairs will continue as long as wages are related to efficiency. The maximum efficiency of A is three times that of B, and the minimum is twice that of B. If wages in B are Re. 1/- they should not be Rs. 3/- or more or Rs. 2/- or less in A. That is to say, in order that the principle of Comparative Costs may apply, the ratio of money wages between the two countries must be between an upper and a lower limit.

What will happen if wages are Rs. 3/-

Cost per unit	Rice	Linen	
Country A	Re. 1.0	Re. 1.5	Cost per unit when wages are Rs. 3 per day in A, and Re. 1 per day in B.
Country B	Re. 1.0	Re. 1.0	

There is now no gain to B in buying rice from A. But as the price of linen is lower in B, the other country, i.e. A will import linen. Thus one-sided trade will ensue. A's balance of payment will be passive, so that it will send out gold to B in payment for linen. This flow of gold will raise prices and wages in B if there is gold standard and lower the same in A. Eventually, the direction of trade will be the same as before and comparative cost advantage will re-assert itself, with the important

difference that the range of trade and the gain from trade will be narrowed down

Similarly if wages fall to Rs. 2/- in A, there is again one-sided trade, though now A would be exporting rice without any reciprocal imports of linen Gold would flow from B to A, raising wages and prices in A and lowering the same in B, till a new position of comparative advantage was reached.

Hence, the principle of comparative real cost applies under money economy, so long as wages bear the proper relation to efficiency If wages are more than in proportion to efficiency of production will be discouraged till (unless some artificial force keeps it there) it comes down to levels where trade is not profitable, and therefore, not practicable.

Transport costs We had also neglected transport costs which form an important element in all trade transactions But the introduction of transport costs does not in any way upset the Comparative Cost principle All that they do is to narrow down the range of trade Suppose the exporting country pays transport costs

	I		II		
	Rice	Linen	Rice	Linen	
Country A	Rs. .833	Rs. 1.25	Rs. .90	Rs. 1.25	When transport costs are paid.
Country B	Re. 1.0	Re. 1.0	Re. 1.0	Re. 1.15	

The direction of trade is the same as before. But the range of trade is narrowed and the gain from trade is less "A good will not be exported or imported unless the difference in its cost of production between the two countries exceeds the cost of transporting it from one to the other. The export capacity of a country does not depend, solely upon its comparative cost of production, it depends also upon the costs of transport". (Haberler).

More than two commodities. Let us apply the theory to more than two commodities. At any time, a country has resources and equipment for the production of a number of commodities But it is not equally efficient in the production of all, i.e. its comparative advantage differs from commodity to commodity. When a country enters upon trade, it will export those commodities whose comparative cost is lower. How to decide which of these commodities will be exported and which imported?

This is done by finding out the terms of trade or the rate of interchange between exports and imports. And these depend on relative demands of the two countries. If the terms of trade are favourable, i.e., for a small amount of export large amounts of imports are obtained, very little of its own goods will have to be sent out—perhaps only one commodity. As the terms become less favourable, more goods have to be exported than before—one or two more goods may enter the export list. Thus the line of demarcation between exports and imports keeps shifting according to the changes in the terms of trade. International trade, however, continues on the basis of comparative cost advantage, so that the presence of more than two commodities makes no essential difference to the principle.

More than two countries. Here again, there is no fundamental modification in the theory. Suppose there are more than two countries. Take a commodity X. Some countries will be importing it and some will be exporting it. So we divide them into exporting and importing groups. The commodity will be exported first by that country which has the lowest cost ratio, and if it cannot satisfy the total demand due to its cost rising with output, other countries will begin to export in the order of their importance in production.

Variable costs of production. It has so far been assumed that production is carried on under conditions of constant costs. This is not true in real life. How will the principle hold under decreasing and increasing costs, i.e., when the laws of increasing and diminishing returns are operating

Suppose production of both the commodities, in both the countries, is carried on under conditions of decreasing costs or increasing returns. This implies that the marginal cost per unit falls with an increase in output and rises with a reduction in output. Country A is producing more of rice as it caters to the demand of both the home and the foreign markets. Similarly, country B is increasing its output of linen. Hence the cost for rice in A and for linen in B will constantly decrease. On the other hand, country A is producing less linen, as it gains by importing it from B. For similar reasons B is producing less rice. The cost of linen will rise in A, and that of rice in B. Thus the comparative advantage of A in rice, and B in linen goes on increasing with an increase in production. The range of trade will be widened, the advantages from such exchange will increase, and lead to complete specialization, on the basis of comparative cost differences. To illustrate :

	Rice	Linen	
Country A	Rs. .833	Rs. 1.25	Cost per unit. A specialises in the production of rice and B in that of linen.
Country B	Rs. 1.0	Rs. 1.0	

	Rice	Linen	
Country A	Rs. .7	Rs. 1.35	decreasing Increasing cost in operation. The range of trade extends, leading to complete specialization.
Country B	Rs. 1.2	Rs. .9	

Let us take the case of production under increasing cost or decreasing returns As A produces more of rice and less of linen (on the basis of comparative cost differences), marginal costs will rise in the former and fall in the latter. Similarly, B's cost will rise in the case of linen and fall in that of rice. This process may go on till a position of equal difference in cost is reached, resulting in a simultaneous production of both commodities in the two countries. Thus with increased production and trade, the advantages of trade will shrink and the range of trade will be narrowed down. But so long as differences in cost continue, trade will continue. "The division of labour will indeed be carried far less than under comparative cost since as it is extended, the comparative disadvantage of a country at the margin diminishes and finally disappears. But it is profitable to carry it up to that point."

	Rice	Linen	
Country A	Rs. .833	Rs. 1.25	I Cost per unit ; trade as before.
Country B	Rs. 1.0	Rs. 1.0	

	Rice	Linen	
Country A	Rs. .9	Rs. 1.20	II Production under increasing cost. Range of trade has narrowed down.
Country B	Rs. .95	Rs. 1.15	

	Rice	Linen	
Country A	Rs. .93	Rs. 1.17	III Equal difference in cost. Both articles produced simultaneously in both the countries. Up to this point trade is on the basis of comparative costs.
Country B	Rs. .93	Rs. 1.17	

If, however, diminishing costs operate in one branch of production, and increasing costs in the other, the position becomes somewhat unstable. The existence and range of trade will depend upon the relative strength of the forces of diminishing and increasing costs. Thus, as shown below, if the export industry is under increasing costs and the import industry under decreasing costs, when the tendency to diminishing costs is stronger, the advanrage of trade will further extend.

	Rice	Linen	
Country A	Rs. .833	Rs. 1.25	
Country B	Rs. 1.0	Re. 1.0	
Country A	Rs. .9	Rs. 1.4	The tendency to diminishing costs is stronger.
Country B	Rs. 1.2	Rs. 1.3	
Country A	Rs. 1.2	Rs. 1.6	In spite of rise in the cost of export commodities, trade will have the same direction as before.
Country B	Rs. 1.8	Rs. 1.5	

But if the force of increasing costs is stronger, the advantage will gradually dissappear, the commodities will be produced simultaneously in both the countries, and the extension of the exchange of goods will stop. To illustrate ;

	Rice	Linen	
Country A	Rs. .833	Rs. 1.25	The tendency to increasing costs is stronger.
Country B	Rs. 1.0	Rs. 1.0	
Country A	Rs. ·95	Rs. 1.26	Cost differences are narrowing down.
Country B	Rs. I.1	Rs. 1.2	
Country A	Rs. 1.2	Rs. 1.28	Position of equal differnce in costs. Both countries produce the two goods ; no trade.
Country B	Rs. 1.2	Rs. 1.28	

It can similarly be shown that if export industry is working under decreasing costs and import industry under increasing

costs, the same conclusions as arrived above will hold good If the tendency to decreasing costs is stronger, trade will continue, if the opposite be the case, goods will pass out of international trade

Case I	Rice	Linen	Rice	Linen
Country A	Rs 833	Rs 1 25	Rs 69	Rs 1 1
Country B	Rs 1 0	Rs 1 0	Rs 8	Rs 9

Decreasing costs are a stronger force, hence the direction of trade is the same as before

Case 2	Rice	Linen	Rice	Linen
Country A	Rs 833	Rs 1 25	Rs 6	Rs 95
Country B	Rs 1 0	Rs 1 0	Rs 6	Rs 95

Increasing costs are the stronger factor After a time trade will end, since the cost differences have disappeared

Conclusion The removal of assumptions does introduce certain modifications, but it does not invalidate the principle of Comparative Costs The essentials of the theory remain unassailed

Factors Affecting Gain from International Trade

According to Taussig, the extent of a country's gain from trade depends upon two factors first, the terms of international exchange, or terms of trade, and second, the efficiency of its labour in producing exported commodities

By terms of trade is meant the ratio at which goods exchange between two countries Taking the example of countries A and B, if the ratio of exchange is 1 unit of rice for 1 unit of linen, A gains 1/3 unit of linen, because in the absence of trade it gets only 2/3 unit of linen for 1 unit of rice (according to the rate of exchange between the two commodities in A) But at this ratio B does not gain at all and will not be tempted to engage in trade with A. If, on the other hand, the ratio is 1 unit of rice for 3/4 unit of linen, B gains 1/4 unit of linen at every transaction For in the absence of trade it must give 1 unit of linen to procure 1 unit of rice, now the sacrifice is less Any rate of exchange of 1 unit of rice for more than 2/3 unit of linen but less than 1 unit of linen will confer a benefit on both the trading

partners. The nearer the rate is to 1 unit of rice =2/3 unit of linen, the smaller is the gain to A and the larger the gain to B. Conversely, the closer the rate is to 1 unit of rice = 1 unit of linen, the greater is the gain to A and the smaller the gain to B. It is clear, then, that the terms of trade play an important part in allocating a share of the gain to two countries having trade relationships with each other.

But, as hinted above, the terms of trade are constantly changing. What is the force responsible for variability in the terms of trade? J. S. Mill calls it 'Reciprocal Demand'. It means the relative elasticities of demand of the two trading nations for the commodity of the other, or 'the demands of the two countries for each other's product in terms of their own product'.

The rate of exchange between the two countries will be one at which equilibrium is established, or at which the value of a country's exports is equal to the value of its imports. The country with an inelastic demand is prepared to give more of its commodity for a certain amount of the other's when a shortage in the supply occurs, (e.g. if A's demand is inelastic, it will give more rice for a unit of cloth). The terms of trade will be unfavourable to A, and consequently its gain from trade will be reduced. On the other hand, if a country's demand is elastic, it will offer less of its goods to procure a certain amount of the other's in similar circumstances; (if A's demand is elastic, it will offer less rice for a unit of linen). Now , the terms of trade will become favourable to A, and the gain from trade will be larger. To illustrate, suppose at the rate of exchange of 1 unit of rice for 5/6 unit of linen, exchange between A and B is in equilibrium, i.e., (imports just pay for exports). Let us say that for certain reasons, A's demand for linen increases, but B's demand for rice remains as before. A will be prepared to offer more attractive terms to B, i.e., more rice than before for the same amount of linen, in order to induce B to send more linen. Obviously, the greater intensity of A's demand for B's products will shift the terms of trade against it. But at the new rate, which is favourable to B, (say, 1 unit of rice for 3/4 unit of linen), B may buy much more if its demand is elastic, or it may buy just a little more if its demand is inelastic. In the former case the terms of trade will be less adverse to A than in the latter case. In the former case A's gain will fall by a smaller amount than in the latter case; and converse for the increase in the gain to B.

Thus 'Reciprocal Demand' affects not only the terms of trade, but also the gain from trade. In the words of Taussig: "That country gains most from international trade whose exports are most in demand, and which itself has little demand for the things it imports, i.e., for the exports of other countries. That country gains least which has the most insistent demand for the products of other countries."

The second factor determining a country's gain from trade is its efficiency of labour in producing exported commodities. Efficiency of labour is responsible for the differences in the cost-ratios, between the trading countries. An increase in the efficiency, widens the differences in the comparative costs, and thereby widens the field in which profitable trade can be conducted by the nations concerned. The greater the efficiency of a country's workers in its export industries the more its exports will be in demand Thus according to Taussig's statement "that country gains most from trade whose exports are most in demand", the gain from trade will be more. Moreover in such a country, the general level of money income will be higher. But more important is the fact that their real income will also be higher. For they will be able to procure more of foreign goods in exchange for their larger output of export commodities.

In explanation of the above it must be mentioned that another important factor determining gain from trade is the level of the money income of a country. Other things being equal a *high general level of income* is the outcome of an efficiently conducted export industry. "The country whose demand is great for the products of the other country will have comparatively low prices and low money incomes; the country whose exports are in insistent demand in the other country will have *comparatively high money wages and money incomes*." For, if a country's exports are in great demand outside, it will have a flourishing export trade and the wages of the workers will be high *in* the export industry. This will set the tone for wages in other industries, since, under competition, labourers will tend to gravitate towards the export industry where wages are high, unless retained in other industries by their willingness to pay equally attractive wages The opposite will be true for a country whose exports are not so largely demanded. But, as mentioned before, there is an added advantage to the country with a high level of money income. *It has* to pay the same for foreign

goods as any other country (barring differences due to costs of transport). Internationally traded goods have the same price everywhere. Naturally, an American with higher income will get more satisfaction from such imports than an Indian with lower incomes. 'The real gain from higher money incomes is secured from the lower prices of articles of import.'

CHAPTER XLVII
COMMERCIAL POLICY

By Commercial Policy or Trade Policy is meant "all measures regulating the economic relations of a country" Through the history of international exchange two main policies have held the field These are Free Trade and Protection

Free Trade

Free Trade implies freedom of international exchange Under such a policy there are no barriers to the movement of goods from one nation to another, and exchange is allowed to take its natural course

Protection Protection implies restriction of trade between nations, generally exercised to give shelter to some home industry when it is faced with foreign competition By keeping out partially or wholly the imports of commodities, an opportunity is provided for the growth and development of the home industry All measures of intervention, no matter what their ultimate objective is, if they raise any artificial impediment to the normal course of international exchange, are referred to as protective measures

In order to decide the relative merits of these two policies, there must be some criterion or standard of judgment The proper standard is the 'maximization of the social product' All economic activity aims at producing wealth for the satisfaction of human wants Obviously satisfaction will be high if the total product is high, i e , if the social product is at the maximum Therfore whichever policy promotes such maximization must be deemed desirable

The case for free trade The basis for free trade lies in the division of labour If we take a group of people, it will be seen that through division of labour and specialization each will produce that commodity for the making of which he is most fitted Exchange then takes place and confers benefits on all the participants No doubt, each one if he made the attempt might succeed through his own efforts in satisfying his wants, but the total product and consequently satisfaction would be less than under specialization Hence, the greater the division of labour and specialization the greater is the gain and economic prosperity

Apply this policy to nations and we have the justification for free trade. Because of natural and other facilities, each nation is suited for the production of some special commodity. When there is specialization, the labour and capital of a country tend to move into those channels of industry where their contribution is maximum. Such territorial specialization brings gains to all concerned and maximises their social product when international and inter-regional trade is entered into with a free flow of goods. Any obstacle to the free movement curtails the possibilities of specialization and to that extent reduces the social product. "Therefore, since the income of any commodity or nation is large just in proportion to the extent to which it specialises, the greatest possible freedom of trade is justified."

The arguments for free trade are based upon its advantages, and may be summarised as follows:-

Free trade procures imports at cheap rates. The gain from this lies in an increase in the real income in terms of goods and services. Since the foreign country has natural advantages in producing the commodity we import, any attempt on our part to produce similar goods will involve unprofitable locking up of our productive resouces. "By trading we are thus enabled to free some portion of our productive resources for the satisfaction of other wants. As a result, our national income is larger by whatever these released resources produce." It is said that this argument favours consumers at the cost of producers. But such is not the case. For under free trade, though consumers gain through low prices, producers also gain as the factors of production are directed towards that part of the economy where they can contribute and therefore earn most. Specialization, be it local or international, confers benefits on the consumer and the producer alike.

Free trade makes difficult the establishment of harmful monopolies. When trade is unrestricted, healthy competition exists and there are few possibilities for the growth of monopolies. There is thus a 'tendency towards the improvement of industrial technique', arising from an expansion of the area of competition.

PROTECTION

Methods of giving Protection. In the present era, protection is a regular feature of the commercial policy of all countries. Various methods have been tried, depending upon the object in view and the needs of the time. In general, protection may be given in any of the undermentioned ways.

Tariffs or imports duties. These duties are charged on goods which are a rival to similarly produced home articles. They cause a rise in the prices of these goods. This gives the home producer a better chance to compete with the outsider. If the duty is very high, the price rises so high that the commodity finds no market in the taxing country. In that case home production can flourish unhampered.

Bounties. Refers to the grant of monetary help by a government to a struggling home industry to enable it to face foreign competition successfully and stand on its feet in due course of time A new industry has high costs of production, and therefore, charges high prices for its output. If some foreign producer is able to sell at a lower price, he can be met on equal terms only if the cost of production of the home producer is lowered Through the grant of a bounty, government meets a certain portion of the cost and facilitates the growth of the internal industry Such assistance was given to the famous Tata Iron & Steel concern during the days of its inception and growth.

Quotas. This involves quantitative restriction of imports A limit is placed upon the amount of foreign goods that are allowed into the home market As soon as this limit is reached, imports are terminated. Under a quota system, the home producers know how much will come from outside. They are, therefore, free to produce enough to meet the home demand.

Commercial treaties. By mutual agreement, two nations decide to extend trade facilities to each other. This generally takes the form of the Most Favoured Nation Clause. Whatever concessions are given by either nation to a third nation are automatically extended to the other contracting partner. The range of trade is consequently widened when such treaties prevail*. It may also take the shape of a bilateral trade agreement, under which two nations decide to regulate their trade through a mutually satisfactory agreement.

Exchange control The rate of exchange and the amount of foreign exchange available, depend upon our Balance of Payments, of which the most important item is export and import of goods and services. In order to maintain a desired rate, rigorous supervision of foreign trade and foreign payments becomes necessary. Exchange control is a very effective weapon in the hands of the monetary authority and facilitates the planning of foreign trade and its direction into desired channels. The last two world wars have witnessed a steady progress in the efficiency of exchange control mechanism. Clearing agreements and Exchange Equa-

lisation Fund are devices of furthering a policy of exchange control. Inasmuch as measures of exchange control can be utilised for diverting production into desired channels, they are protective, in character.

Exchange depreciation. Under this system, the value of a currency in terms of another is purposely lowered so as to encourage exports and discourage imports. When there is such a fall in the value of a currency, the goods of that country become cheaper to foreign purchasers. Demand for such goods is artificially stimulated, and the exports increase. On the other hand, a fall in the value of a currency in terms of another means that foreign goods become expensive for the depreciating nation. Imports are automatically reduced. Thus in the new set-up, the home industries can step up production to meet the additional demand. The effects of depreciation are, therefore, precisely the same as those of protection.

Arguments for protection. Protection is an established creed of modern commercial policy. Good or bad it has come to stay. But whether it is a healthy policy, leading to an economic millenium or a policy fraught with hidden dangers remains to be examined. The champions of protection are often swayed by a prejudicial outlook, rather than guided by a detached, scientific perspective. "Indeed, some arguments which are scientifically quite untenable and which can be refuted in a few sentences have the greatest influence in practice, in parliament, and in the discussion of the subject by interested parties and the press."

Undoubtedly, some arguments for protection appear valid and convincing if judged from the standpoint of national defence, or the maintenance of a particular group or tradition. But our standard of judgement is 'maximisation of the social product'. Any argument on commercial policy stands or falls according as it increases the social product or lowers it.

The pauper-labour argument. The advocates of this argument assume that a country with high money wages will be undersold by a low wage country. Therefore, protection is justified on the ground that it keeps out goods made in low wage countries, and eliminates injurious competition from that source. This, it is claimed, helps in maintaining high wages and a high standard of living in the protected country.

Criticisms. This argument is not always applicable. For in most cases high wages are paid because labour is more efficient, i.e, its marginal productivity is greater. Hence if the

productivity or effectiveness of labour is proportionately greater in the high wage country, as compared to the low wage country, it suffers no handicaps

Had the pauper labour argument been correct, the low wage nations of Asia and Africa should have swept their economically advanced western competitors of America and Europe from the world market High wage countries like U S A, and Britain would stand no chance in markets of the orient But facts prove otherwise These highly industrialised nations of the west continue to dominate world trade in spite of the comparatively higher wages paid This is so because the efficiency of their labour is in keeping with the high wages Such industries require no protection they merit their domination

In all industries enjoying comparative cost advantage high wages can be paid and low prices charged, still leaving a margin of profit for the producer It is only in industries which do not possess this advantage that high wages cannot be maintained without adequate protection Such industries, whose very existence depends on duties are the most clamourous in publicising the pauper labour argument On the basis of our criterion of maximum social product, these industries are a burden to the nation Factors of production locked up in these could be profitably mobilised for use in branches of production where the nation has comparative cost advantages Obviously then, if protection is called upon to support the artificial high wages of some unnatural industry it may be justified from some other point of view, but definitely not from that of maximising social product, which is our acid test

The home market argument According to this, protection restricts imports, stimulates home industries and thereby creates a home market for indigenous products If we do not buy from a foreign supplier, we will, naturally buy at home

Criticism But it must be remembered that curtailment of imports will ultimately reduce exports by an approximately equal amount If there is a gain to the import industry, there is a loss to the export industry The loss of foreign market to the export industry will create unemployment there and to that extent adversely affect the general prosperity of the protecting nation Moreover, the stoppage of export industries is a serious matter as it is in that sphere that our nation has advantages of comparative costs and therefore of specialization To develop some new industry at the cost of the export industry involves at least for some time an uneconomic allo-

cation of productive resources, and a corresponding fall in the social product.

As Taussig says, "To cut off imports means to cut off exports also ; it means simply the substitution of exchange within the country for exchange between countries." This type of exchange will impose a greater burden upon the consumers, because the home made goods (not having comparative cost advantage) will cost more than the previously imported similar imports.

Argument for keeping money at home. This argument reflects a rabid mercantilist outlook. Its supporters claim the sympathy of no less a person than Abraham Lincoln, who is alleged to have said "I do not know much about the tariff, but I know this much, when we buy manufactured goods abroad we get the goods and the foreigner gets the money. When we buy the manufactured goods at home we get both the goods and the money."

Criticism. As Beveridge caustically remarks, "The only sensible words in it are the first eight words." In foreign trade goods exchange for goods, money is only a medium which facilitates such transfer. If money is kept within the geographical boundaries of a country and imports are prohibited, the consumers have to pay much more for the expensive home made articles. Their real satisfaction would be greater if cheaper foreign products were allowed entry. Money, after all, is the means to an end and not an end in itself. The emphasis should be on maximum satisfaction rather than on maximum money inflow. To accept the above argument is to deny the advantages of international division of labour.

Purchasing power argument, and the argument for all round protection. Agriculture explains to industry that protection to agriculture would be advantageous for industries because through protection agriculture would have more income or purchasing power which could be spent on the products of home industries. Similarly industry appeals to agriculture to support industrial protection. 'The parties who would gain by duties try to make their wishes palatable to others'. Taken to its logical conclusion, such mutual assistance would result in an all round protection.

Criticism. The more encircling a tarriff, the less is the gain to the protected industry. 'For all members of that industry must now pay more dearly for all other imported goods and thus in their capacity as consumers they lose part of their gain as producers'.

Further import industries gain at the cost of export industries The more encircling is the tariff wall the more isolated is the protecting country It foregoes the benefits of international division of labour Alongside of this a less profitable use is made of the factors of production To quote Ellsworth Land, labour and capital which would have been devoted to producing exports with which to procure the article granted protection would now be transferred to the protected industries That their productivity is lower in these lines is proved by the very fact that protection is necessary '

Equalisation of costs argument This is often referred to as the scientific solution of the tariff problem On the face of it motives of justice and fair play appear to provide the inspiration for this argument It says, let us equalise the cost of production of the home and foreign producers and after that let the best man win

Criticisms Were this idea to be translated into practice it would uproot the very basis of international trade Trade is carried on because of differences in costs(resulting from comparative advantage) The removal of cost differences will bring down the whole fabric of trade between nations In the words of Ellsworth Such a policy if consistently followed, means the complete wiping out of all the advantages from international trade, nay, the wiping out of international trade altogether The greater the disadvantage of a country in producing a given commodity the more labour must be given to producing it and the higher will be the expenses of the employer " This policy puts a premium on inefficiency

Argument based on retaliation and bargaining Protection is justified as a measure for bringing erring nations to book. If another country restricts our goods, we pay it back in the same coins Needless to say there is some psychological and emotional satisfaction in such a tariff war

Criticism As against this it can be said that free trade gives advantages whether or not all countries are practising it The nations which restrict imports forego the gains of international specialisation To imitate their undesirable action is tantamount to cutting one's nose to spite one's face Beveridge condenses the free trade case by saying, If one country has good harbours while all the rest have bad ones it will not realise the advantages of its good harbours so fully as if all the rest had good ones also But it will realise some advantage, it will be better off than if it too, sank rocks all round its coast '

Infant industries argument. Surprisingly enough this argument has been put forward by recognised free traders. As a matter of fact this is the one really serious argument for protection. The chief proponents were first Alexander Hamilton (U. S. A.), List (Germany) and J. S. Mill (England). According to them, there may be natural advantages in a country, favouring the growth of a particular industry, but in face of competition from strongly entrenched foreign industires, these potential enterprises fail to spring up. Therefore, it is suggested, that in the initial stages of their growth when they are comparable to infants, the state must arrange for proper protection and nurture the growing infant till it reaches full and healthy maturity. Protection must, however. be temporary. It must extend for a period long enough to assist the new industry to tide over the pangs of genesis and early growth. "At the outset the domestic producer has difficulties and cannot meet foreign competition. In the end he learns how to produce to best advantage and then can bring the article to market as cheaply as the foreigner, even more cheaply." (Taussig).

Criticism. As stated before, this argument is advanced by free traders. Its theoretical validity cannot be disputed. But the danger of such protection is two-fold. The first is due to the difficulty of deciding what particular industry can rightly be termed infant. And then, once protection is given and an industry develops in the sheltered economy, the realization that it is not an infant (i.e. it does not have the requisite natural advantages) cannot easily lead to the withdrawl of protection. If at all such withdrawal is made, it is bound to bring in its wake economic dislocation and untold suffering—at least in the short period. That is why once an industry is protected, even if it is found unsound, vested interests are created who fight tooth and nail, any proposals for eliminating protection.

Secondly, experience has taught us the truth of the saying, once an infant always an infant. Protected industries tend to become supine and depend more and more upon state support, so that their existence, far from maximising social product, reduces the sum of national welfare. 'Even when the infant becomes a powerful giant he is unwilling to relinquish his teething ring'.

Protection to safeguard against dangers of specialised industries. The policy of keeping all one's egg's in the same basket is fraught with numerous dangers. For in a period of economic depression, or a war, the national economy would receive a serious set

back. The pangs of adjustment and shifting of resources from one enterprise to another would further lacerate the wound. To avoid such dark possibilities, protection is advocated. Its assistance can be summoned to diversify production which 'would result not only in a higher average national income in the long run, but also in the manifold benefits of greater stability.'

Criticism. The argument has reason and power. But experience proves that certain types of depression (caused by trade cycles etc) have hit protected countries harder than non-protected ones. U. S. A., for example, felt the impact of the pre 1931 depression more than did England although it was better protected To follow a protective policy so as to lessen the shock of war time adjustments 'would be so costly in terms of lowered standards of living as to be out of the question for most countries'.

One of the fears of specialization is that other nations reach industrial maturity and reduce foreign imports. This is one of the reasons for decrying specialisation. But such fear is ill founded. The rapid industrial progress of western nations has not extinguished trade between them, and specialization still has a wide scope.

The argument fails to take cognisance of the sacrifices involved, in terms of loss of efficiency, higher cost to producers and prices to consumers. And is it "not better to open up the channels of international trade as a means of reducing national rivalries and tensions and thus of lessening the chance of war, than it is to withdraw into ourselves and thus to add rather than subtract from economic difficulties which confront nations"?

Protection to military and key industries. 'Defence is more important than opulence' is an old and oft repeated dictum. In the present era of scientific warfare this argument appears strong. For no nation can prosper if its defence is weak. Economic development is possible only in conditions of peace and security, hence protective measures resulting in such security are advantageous and cannot be criticised.

Protection and India

A study of the pros and cons of free trade and protection, leads to the conclusion that from the stand point of 'maximum social product', protection can seldom be justified, except in the case of 'infant' industries. For, if an industry is really; an infant, its development increases the total product and consequently the national income.

In India the infant industry argument assumes a far greater importance than elsewhere. That is why, selective or discriminating protection is suggested without violating any canons of free-trade, as a remedy for certain economic ills.

Our economic and political background is one of foreign domination by a highly industrialised and commercial nation. On many an occasion, the commercial interests of India were subordinated to that of the foreign ruler, with the result that our commercial and economic policy had perforce to toe the line of the alien master. In the light of this it is not surprising that Indian industries have been deprived of opportunities for healthy growth ; Indian agriculture has continued in the age long rut of eking out a bare living for the tillers of the soil ; and Indian cottage industries have succumbed in face of competition from foreign manufactures. The net result is a fall in our social product.

None can deny India's possession of rich natural resources. Our country is rich in raw material, in sources of power and in human resources. It has immense possibilities of industrial growth and expansion. Faced as we are with competition from experienced, advanced and strongly entrenched foreign producers, the only way to develop our industrial potential is to shelter it during its infancy and early growth. Such a protective policy will raise the national income. (A study of discriminating protection in India proves beyond doubt the possibilities of rapid growth under favourable conditions.)

It is not for a moment suggested that all round protection should be given, nor is it suggested that any industry should be termed an infant just to merit state help. Rather, there should be thorough investigation and careful selection of industries which appear to have a bright future, and then only should they be nursed through a protective policy, till they reach their full stature. Once this position of stability is reached, protection should be withdrawn. As an instance reference may be made to the Tata Iron and Steel Works, which could not have grown to its present strength without adequate protection. But now, it is strong enough in certain branches and has ceased to receive state help in those particular fields.

Then again, India's being an agricultural country means that its economic development cannot be brought about at the desired speed unless proper protection is given to a number of productive enterprises. In the words of Pigou : " The case for protection with a view to building up productive power

is strong in any agricultural country which seems to possess natural advantages for manufactures In such a country the immediate loss arising from the check to the exchange of native produce for foreign manufactures may well be outweighed by the gain from the greater rapidity with which the home manufacturing power is developed The crutches' to teach the new manufacturers to walk, as Colbert called protective duties, may teach them this so much earlier than they would have learned it if left to themselves, that the cost of the crutches is more than repaid

Finally, protection may be advocated not from the point of view of maximum social product, but from that of practical politics In a world torn with strife and power politics, no nation can neglect its defence This automatically implies the growth of virile nationalism leading to attempts towards economic self sufficiency India has to retain her newly achieved independence It must, therefore, have a strong defence and a diversification of its industries The ideal state of affairs would be that in which there were no tension between one nation and another, and the channels of international trade and commerce were thrown open to all But so long as sanity does not prevail in international relations, and man rushes from one world conflagration to another, each nation will have to look after its own interests, foregoing wealth and welfare that could have otherwise been possible.

Imperial Preference

Meaning It implies the formation of a group of several nations bound by a common tie, each showing preference for the goods of the other as against the goods of nations outside that group Historically speaking the term denotes a group formed by nations belonging to the British Empire In practice, lower duties are charged from members and higher from non members

Origin In the last decade of the 19th century, Great Britain was faced with serious competition from products of other European countries, in foreign markets A large part of the actual and potential markets of Asia and Africa, as also Canada, Australia and New Zealand was under the sphere of British political and commercial influenee To maintain such dominance British trade policy veered towards the scheme of Imperial Preference by strengthening the ties of trade between nations belonging to the empire

Imperial Preference can be successful provided certain basic conditions are present. First, all the parties concerned must have some possibility of give and take, and secondly, the entire area over which Imperial Preference is enforced must be, on the whole a net importer from abroad. For if it is a net exporter the non-member countries may take recourse to retaliatory measures and cause a loss to the whole group.

On the whole, a policy of Imperial Preference is less injurious than tariffs. The latter consists of an increase in duty and restricts the scope of trade. But Imperial Preference, though it restricts trade between one area as against the rest of the world, makes possible conditions of free trade within that area. It is a step leading to greater freedom of trade provided the area in question is large.

A serious drawback, arises, however, when we compare the gain to manufacturing and agricultural countries. The Fiscal Commission of India 1921, remarked : "Manufactures nearly always met with competition in the foreign markets, and, therefore, a preference on manufactures is nearly always of value. The position in regard to raw materials is different. In the first place they are usually admitted free into foreign markets, so that the possibility of a preference does not arise ; in the second place it is an obvious fact that to a large extent they find their markets ready made, whereas the market for manufactures has to be developed and carefully nursed. With comparatively small degree of competition to meet, it is clear that raw materials stand very much less in need of preference than do manufactures, and that the gain to them by preference is likely to be correspondingly smaller. With regard to foodstuffs, the general tendency in most countries is to admit them free and the possibilities of preference are limited." Add to this the difficulty of administration, often resulting in chaotic commercial conditions, and the ever present danger of political bickerings and trade retaliation by countries outside the golden circle.

India and Imperial Preference. Despite the majority report of the 1921 Fiscal Commission which considered Imperial Preference injurious to India, we were asked to join the scheme on the grounds of 'loyalty to the empire'. It was strongly held, however, that certain principles should govern the trade pacts with empire nations. First, that there should be no grant of preference on any article without the approval of the legislature. Previous to the legislative decision, the Tariff Board

should examine the proposals Secondly, no preference should be given so as to diminish the protection required by industries And finally that the balance of gain and loss should not be unfavourable to India Thus 'preference with protection' was foisted on India through a number of trade treaties ranging from 1927—32—35—& to 39 The best known of these is the famous Ottawa Pact of 1932.

A post mortem of Imperial Preference in India shows that any gain we may have had is negligible There are many facts to prove this First, India's exports have for the large part consisted of raw materials and food stuffs, which require no preference. Moreover, as similar raw materials and food stuffs are produced by other empire countries also, we had to face a stiff competition within the imperial structure Secondly, the only market for Indian manufactured coarse quality goods was outside the empire Thirdly, India has been a backward agricultural country, whose dire need is industrial growth and expansion The policy of Discriminating Protection can succeed, if foreign competition is held in check no matter what its source But so long as we give preference to manufactured goods, the object of protection is defeated "If India is to develop her industries rapidly and with minimum burden upon the consumers it is essential that the protection should be adequate against all competitive imports, irrespective of country of origin The accepted policy of Imperial Preference will impair the effectiveness of Discriminating Protection In adequate protection is a serious danger" Fourthly, for articles which do not constitute an unfair competition with our goods, it is in our interest to buy from the cheapest supplier and not limit our choice to countries enjoying Imperial Preference Fifthly, in a number of agreements with Britain there has been an absence of reciprocity which is detrimental to us A study of the various trade treaties will bear this out And finally, as has been pointed out by a critic, 'India's abstention from the scheme of Imperial Preference would have meant a vindication of the principle of sanity in the regulation of international trade, and probably caused serious damage to the scheme

The future of Imperial Preference The post war years have witnessed a rapid disintegration of the British empire. The pressure of historic forces have changed the face of the imperial edifice in spite of Mr Churchill's solemn declaration that he had not become the King's first minister to preside over the

liquidation of the British empire. With the independence of India Britain has lost her Asiatic sphere of influence. And yet for some Commonwealth countries there may be a voluntary inclination towards imperial preference if there are no back door tactics and a same liquidation is allowed to their sterling balances,

Discriminating Protection

The Indian Fiscal Commission 1921, appointed as a result of strong public sentiment in favour of protection, decided in favour of a policy of 'Discriminating Protection' for India.

When a certain industry, or a number of industries, which have possibilities of development, but have not shown appreciable progress because of foreign competition, are selected and given protection, the process is referred to as one of discriminating protection. This implies that protection is not general or haphazard, but is given only to deserving and promising industries.

As to how a promising industry is to be selected, the Commission laid down three conditions which must be satisfied, before protection was granted to an industry.

1. "The industry must be one possessing natural advantages, such as an abundant supply of raw materials, cheap power, a sufficient supply of labour, or a large home market."
2. "The industry must be one, which without the help of protection either is not likely to develop at all or is not likely to develop so rapidly as is desirable in the interests of the country."
3. "The industry must be one which will eventually be able to face world competition without protection."

A Tarriff Board of three members was appointed to examine the claims of an applicant, and if satisfied as to the genuineness of the appeal, to recommend to the government proper measures of protection.

It must be said in favour of discriminating protection that it has brought about the rapid growth of some of the major industries of India. The Iron and Steel industry, which was the first one to be protected, has grown to healthy maturity, and is now able to face world competition without any help from the state. There has also been rapid development of the

Sugar industry, the Paper industry, the Match industry and the Cotton Textile industry. Some of these—noticeably the Sugar industry—are able to meet practically all of our internal demand. Subsequent to the appointment of the new *ad-hoc* Tariff Board in 1945, more industries have sought and been granted protection.

There are two important criticisms against the policy. First is the rigidity of conditions, which hampers rapid industrial development. Instances are not lacking where the conditions for protection were interpreted in a very narrow and rigid manner, as a result of which certain deserving industries were deprived of state-assistance. An industry may not be favourably placed with regard to all the natural advantages, i.e., raw material, power, labour and market. But it should be remembered that some of these facilities arise automatically on the growth of that industry—particularly those referring to labour and market. To insist upon the presence of all these advantages at the very outset may often be unfair and lead to a short sighted policy. Thus the Glass industry was refused protection in 1928, as Soda-ash forming only 25% of the raw material was not available in India. Later in 1932, in spite of favourable recommendation by the Tariff Board, the government shelved the report and rejected the appeal. Similarly, the electric wire and cable industry, had all the facilities except the availability of raw material (which was imported), but it was not considered good enough for protection. Worse was the plight of the Magnesium Chloride industry, which sought protection in 1925, against a ruthless German monopoly, but was refused on the ground that the industry can exist without protection. "The fears of the Minority Report of the Fiscal Commission that these conditions are stringent and that they will delay the industrial development of the country, have come true". The growth of the Textile industry in Japan and Lancashire, and of the Jute industry in Dundee, show that even when all natural advantages are not present, protection granted on the basis of a few favourable factors, can prove very successful. It is, therefore, necessary that when applied to a backward country, the rules should be more sympathetically and liberally interpreted.

The second drawback is that the Tariff Board has often proved ineffective and suffers from all the disadvantages of an *ad hoc* body. Its findings have sometimes been arbitrarily rejected. Under a policy of discriminating protection so much

devolves upon the strength and ability of the Board that any weakness in it is sure to have adverse effects on the whole system.

But these are not so much the defects of the system as of its application. As such there is every hope that an improvement in the method of application will rectfiy past mistakes. Taken by itself, the policy of discriminating protection is more sound and sensible than one of general protection. As a backward agricultural nation, India must protect its infant industries. The best results are likely to be achieved under a sensible and balanced policy of discriminating protection.

The Indian Tariff Board. The Indian Fiscal Commission 1921, favoured a policy of discriminating protection, and suggested that the work should be done through a Tariff Board (of 3 members nominated by the government), which will examine the need for protection to an industry and will make the necessary recommendations to the government. The Commission were of the opinion that the Board should be a permanent body and enjoy wide powers. But the first Tariff Board replaced by the new one appointed in 1945, is an *ad hoc* organisation. The new Tariff Board was specially entrusted with the task of formulating a tariff policy in relation to India's post war needs and 'to enquire into claims of protection or assistance' from industries started or developed during wartime.'

Critical estimate. Though the Tariff Board has functioned creditably in many ways, it is open to criticism on several grounds.

First and foremost is the fact of its being an *ad hoc* body, so that it suffers from the shortcomings inherent in any temporary organisation. Members of the Board, being uncertain of their future, may try to please the government so as to consolidate their own position. 'Impartial outlook under these conditions is a mere illusion.' It is also difficult to get really competent people on a temporary body. Further, only if members are permanent and not likely to join any business house after retirement, will they enjoy the confidence of industrialists and businessmen from whom information is likely to be sought. The transitory status of the Board is not conducive to confidence. This difficulty of ensuring secrecy (so essential for getting correct information) results in confidential information being sometimes refused or if given, being unreliable.

It is, therefore, essential that the Board should be a permanent body 'so as to ensure consistency and continuity of policy.' Then alone can it command technical knowledge,

and take an impartial view while making recommendations resulting in a growth of a stable policy, public confidence, and of investment

The second defect has been the limited powers enjoyed by the Board It functions in a purely advisory capacity and its recommendations are not binding on the government Often it investigates only such applications as are forwarded by the government There is then duplication of work and if the scope of investigation is limited the recommendations based on it will also be limited A serious defect is that the Board has no powers of eliciting information Consequently, recommendations are in danger of being based on inaccurate data or second hand information What is needed is, that greater initiative in investigation should rest with the Board

Lastly in spite of the Fiscal Commission's emphasis on the need of publicity, the Tariff Board has not lived up to it The government should publish reports immediately, whether it agrees with the Board s view or not Such prompt publicity raises public confidence Unfortunately, it has been otherwise Reports were allowed to become obsolete, and sometimes it was years before they were published Apart from other evils, this is a waste of public funds It is however, encouraging to note that the new Tariff Board has shown some improvement in this direction

And yet, it is not quite fair to criticise the working of the Indian Tariff Board, bound as it was to the chariot wheels of alien rule and economic policy The new Board is given wider powers and has more scope for work Now that the whole political set up is changed and India is the mistress of her own destiny one may anticipate greater co-operation between the government and the Board and a change in its general attitude and working

CHAPTER XLVIII

EXCHANGE CONTROL

The modern era is one of planned economies. It has witnessed the extension of state interference in numerous branches of economic activity. When government interference with the free play of economic forces enters the foreign exchange market, it is called exchange control.

Exchange control refers to all methods of intervention, direct and indirect, undertaken by the monetary authority to influence exchange rates, or the dealings therein.

Objects of exchange control. The chief object of exchange control is to neutralise the effects of abnormal movements of funds (to or from the national currency), on a nation's currency and economy. Such movements are initiated by speculative activities, economic depression, and sometimes political uncertainty. Liquid balances flow rapidly from one money market to another, causing marked changes in the supply of and demand for some currency , and thereby in its value in terms of other currencies. The country so effected is faced with disturbances in its economy, to safeguard against which it may take recourse to exchange control.

Another objective of exchange control is to adjust fluctuations in the balance of trade. The presence of trade barriers and other protectionist devices makes automatic adjustment in the balance of trade impossible. Stronger and more direct action like rationing of currency to importers and blocking of foreign payments is necessary to correct maladjustment in the trade balance.

Sometimes exchange control may be a purely defensive action designed to counter the ill effects , on a country's economy, of restrictive measures of others countries. The remark that exchange control is contagious originates from such tendencies.

Therefore the *raison d'etre* of exchange control is the desire to have a different rate of exchange from what would exist in a free market. This may take one of three shapes.

Over-valuation of currency, i.e. maintenance of a rate higher than would exist in a free market. It leads to increasing imports and in the long run damages national economic welfare ; it may precipitate a depression.

Under-valuation of currency, or a rate lower than in the free market. An under-valued* currency is a depreciated currency. It leads to exports It helps a country to reduce the shocks of a depression by letting her keep her internal prices high in the face of a depression.

Avoidance of fluctuations, i.e. maintenance of a rate equal to that which would exist under conditions of long period equilibrium between the demand for and supply of that currency.

The attempt to avoid fluctuations in exchange rates and maintain them at an equilibrium level, necessitates over-valuation at one time and under-valuation at others. It has been tried in practice, and has had limited success.

To the extent to which it is successful, it ensures stability in the money and exchange markets, and thence in the economy

Methods of exchange control To make exchange management successful, the monetary authority must influence the supply of and the demand for currencies in the desired direction. This may be done by using direct methods or by taking recourse to indirect methods Indirect methods, by their very nature, have a limited field of operation and limited success.

Indirect methods. Prominent among these are first, tariffs or import duties, and secondly, the rate of interest. Tariffs reduce imports, and lower the supply of home currency and the demand for foreign currency. The less a country purchases from others, the smaller will be the payments it has to make. Other things remaining the same, there will be a rise in the value of the currency of the tariff imposing country. But if all nations use tariffs to the same extent, there will be no alteration in the relative values of any of their currencies. If the duties are levied on exports, there is a fall in the demand for home currency, resulting in its under-valuation If a bounty is given to exports, more goods are sent abroad, there is greater demand for the currency and consequently a rise in its value. The second factor, that of interest rates, exercises an influence on the inflow and outflow of funds A high rate attracts funds and investments, causing an increase in the demand for and therefore, in the value of the currency Conversely, a low rate of interest leads to an exodus of funds, and results in a fall in the value of the currency of that country

But these indirect methods have a limited field of operation and during a period of crisis or abnormal economy their effects

*See the Chapter on foreign exchange.

may be negligible, or may take too long a time to be visible. At such critical junctures only strong direct methods bear fruit.

Direct methods. There have been two direct methods used for purposes of exchanges control. The first is *intervention*, which implies that the government enters the exchange market as an active agent to influence supply and demand. The second is *restriction*, which refers to the official obstruction to the forces of demand and supply from entering the exchange market. The former consists of official exchange operations in the desired directions and increases transactions in the exchange market. The latter consists of the prevention of private exchange operations in an undesirable direction, and as such restricts transactions.

Intervention. "By intervention is meant foreign exchange operations undertaken by the monetary authorities with the object of influencing the exchange rates in desired directions.' '

Intervention is used for bringing about over-valuation, under-valuation or to maintain a non-fluctuating equilibrium rate. In the last case, the currency has to be raised in value or lowered in value according to the exigencies of the moment. To be successful in a policy of intervention the monetary authority must be in possession of adequate stocks of both home and foreign currencies, or gold which may be convertible into currencies. If the aim is over-valuation, the rate is said to be 'pegged', i.e, fixed at a higher level than what would prevail in a free market. 'Pegging' becomes necessary when the existing rate is lower than desired, i.e, when the demand for that currency is less than the supply. Hence 'pegging' involves a pushing up of demand and a restriction of supply. In order to do so a country needs large stocks of foreign currency and gold, so that as soon as the value of its currency falls below the 'pegged' rate, it may sell foreign currency and gold in exchange for its own currency and thereby create an artificial demand for its currency and keep up its value. Conversely, when under-valuation is the objective, the currency is said to be 'pegged down' i. e. its value is deliberately depressed and kept below the level which would prevail in a free market. The desire for under-valuation or 'pegging down' shows that in the free market the demand for that currency is stronger than its supply. 'Pegging down' therefore, involves a watering down of demand through an artificial stimulation to supply. This will necessitate large stocks of gold and a nation's own currency, which will be rushed into the market at the crucial moment and be utilised for purchasing foreign moneys.

Thus whatever be the objective of intervention, its success depends on the possession of adequate resources in terms of gold, foreign currency and ones own currency. Generally speaking, 'pegging down' is easier than 'pegging', as it depends on the possession of home currency, and it is easier for a monetary authority to lay its hands on or to requisition, if necessary, stocks of its own currency rather than of a foreign currency.

The exchange equalisation account. It was started by Britain in 1932, and later introduced by America, France and Switzerland It provides the best known example of intervention in practice A brief study of one of these *accounts* is, therefore, undertaken here.

Exchange equalisation account of Britain. When England went off the gold standard in 1931, there was danger of abnormal fluctuations in the value of the Pound, through intermittent influx and efflux of 'hot money' (money offered for conversion now into one currency, now into another) Fluctuations of such nature were bound to have adverse effects on the internal economy of England. To neutralise the unhealthy effects of such movements on the normal rate of exchange, a fund was created in 1932, and called the Exchange Equalisation Account.

The function of this fund is to accumulate sufficient liquid resources (gold, foreign exchange and home currency) in order to meet any financial contingency. Its objective is not to interfere with, or manipulate artificially the normal long term trends, but only to control temporary deviations from the normal rate. In other words, if a rise or a fall in the value of the Pound reflects the real state of economic affairs, the rate so determined is normal, and the Exchange Equalisation Account will not use its resources to bring about an alteration in such a rate.

Control of the Account is vested in the British Treasury, for which the Bank of England acts as agent To start the Account, Pounds were borrowed from the British public, and a stock of home currency was built up. But adequate stocks of home currency provided resources only for increasing the supply of Pounds in the market, i.e. it gave powers to the Account to keep the value of the Pound down to desired levels. However, in the act of keeping the value down, the Bank of England obtained supplies of gold and foreign currency, (Pounds were put on the market and exchanged for other currencies). Now the Account was equipped with resources for both under-valuation and over-valuation.

In the latter part of 1932, the Pound experienced a tendency to a fall in value. Its value had, therefore, to be bolstered up to the intended level. This brought about a drain on the gold and foreign exchange resources of the Account. When such resources were exhausted, the Exchange Equalisation Account was powerless to check further depreciation in the value of the Pound. Fortunately for it, a change in circumastances in the early part of 1933, resulted in a great demand for the Pound. This enabled the account to acquire again necessary stocks of foreign exchange for future emergencies. From that time onward, the Account has utilised its resources, sometimes for maintaining over-valuation, at other times, under-valuation, as dictated by the market conditions. Thus at times Pounds were converted into foreign currencies, and at other times foreign currencies were converted into Pounds.

Exchange restriction. Exchange restriction refers to such actions of the monetary authority as are undertaken to restrict the freedom of foreign exchange transactions and thereby to influence the tendencies prevailing in the foreign exchange market.

Restriction originated due to the weaknesses of intervention. It represents a more drastic, direct, and effective policy. Germany was the first country to introduce Exchange Restriction, in 1931, followed by certain South American countries (notably Argentine), and some countries of Central Europe. The outbreak of hositilities in 1939 witnessed the growth of Exchange Restriction in Britain, France and the Dominion and Empire nations. India has been following such a policy ever since. As a matter of fact at the present time there are more currencies restricted than free.

To understand the working of exchange restriction, a brief study of the German system is made below, since most countries have followed (with modifications) the German pattern.

Exchange restriction in Germany. What were the forces leading to the adoption of such a policy ? In and about 1931, the German currency was facing a serious danger of depreciation, as Germany had contracted (in terms of foreign currency), large foreign debts, mostly short term loans, to build up its war-shattered economy. The payment of these debts swelled the supply of Marks and caused a fall in its value, in terms of Pounds, Dollars and Francs. The demand for German currency was negligible, as its foreign trade had shrunk to an insignificant level. The crisis was intensified by the fact that the creditors insisted upon their pound of flesh, as they anticipated the economic collapse

of Germany in the near future To make matters worse, they refused to accept payment in terms of goods In short, there existed a serious disparity between the supply of and the demand for German currency, and unless this was adjusted, its value was likely to crash down

Beset with these difficulties, Germany decided upon a policy of artificial over-valuation, a resolve strengthened by its nerve racking experiences of post war inflation, whose scars were still present

Thus the government was faced with the task of restricting *the supply of German currency so as to equate it to the demand*

Methods To achieve its end, Germany adopted drastic measures along lines indicated below

To begin with, all dealings in foreign exchanges were supervised and controlled by a central authority and conducted through licences issued for the purpose The next step was to impound or requisition foreign exchange holdings of its citizens Those in possession of foreign exchange, foreign securities, and bonds were asked to declare their holdings and to sell them to the government at a rate fixed by the state Of this, the state retained what it required, and the balance was auctioned to those in need of foreign exchange This resulted in the existence of two rates of exchange One at which foreign exchange was bought by the government (necessarily lower) and the other at which foreign exchange was sold by the government (higher)

Another restrictive measure was, to allow a very small amount of home and foreign currency to be taken out of Germany for purposes of foreign travels There was next, a complete prohibition of certain imports (classed as non essential goods) and a rationing of other imports A prospective importer had to obtain a license from the government and foreign exporters despatched their goods only when they were sure that such permission had been given Germany's import policy was the creation of Dr Schacht's brain and was referred to as his 'New Plan'

Finally, Germany resorted to a policy of 'Blocked Accounts' The property, securities, bank deposits and currency owned by foreigners could not be taken out of Germany It was held by the government in an account, known as 'Blocked Accounts' Those Germans who had to remit foreign debts, did not pay to the creditors, but deposited the amount in terms of their currency with the government, where these were ear-marked in favour of the foreign creditor, but could not be converted into foreign

currency. Foreigners, deprived of the use of these possessions, were often prepared to dispose them of at a discount, or to buy goods from Germany. In either case, Germany gained, of course at the cost of the foreign creditor. Inevitably, the presence of 'Blocked Accounts' created a black market in foreign exchange known as the 'Black Bourse'.

Effects. As a result of these drastic measures there was rapid industrial development in Germany. The elimination of exchange disorders and uncertainty reflected itself in the speedy re-instatement of German economy on a war footing. "The power that exchange control gave the Nazi Government over the activities of the German industry by rationing the supplies of necessary materials was a powerful weapon in the armoury of general economic control. The whole system was run in such a way as to screw out of the world the maximum possible amount of foreign currencies for use in purchasing the raw materials for munitions."

Clearing Agreements. When two countries enter into an agreement under which there is an 'offsetting of payments so that transactions do not pass through the foreign exchange markets', it is termed a Clearing Agreement.

This was introduced as a reprisal to the system of Blocked Accounts.

Illustration. Take two countries A and B. Assume that A has blocked the accounts of B. If B has an unfavourable balance of payments with A (i.e. B has to pay more to A than it receives from it), it can take steps to counter the effects of Blocked Accounts. For now B will freeze the payments due to A by making it obligatory on all its citizens who have payments to make to A, to remit these amounts to the central bank of B rather than to the creditors in A. B will then be in a position to dictate terms to A and insist on payment of its accounts before releasing those due to A.

The fact that two can play at the same game, results in A and B entering upon an agreement, under which payments between them would be offset through their respective central banks. A citizen of country A owing money to someone in B will now deposit the amount with the central bank of his country, which in turn will pay it to some creditor in A who has to receive payment from B. Similar will be the procedure followed by a debtor in B owing money to someone in A and the central bank in B will use the amount deposited to pay one of its citizens who has lent money to a national of A.

Such agreements obviate the need of money passing through the foreign exchange market. Payments are made without any use of foreign moneys. Clearing agreements bring about equalisation of trade between two countries, and introduce a kind of barter in international transactions.

International Monetary Fund

The International Monetary Fund is a result of the Bretton Woods Conference The salient objectives placed by the Fund for its achievement are the following :—

(i) The fund will try to secure exchange stability.

(ii) It stands and will try , for maximum international co-operation in the economic sphere.

(iii) It will attempt to argument free trade between the countries joining it.

(iv) It will make possible the multilateral convertibility of currency and thereby render more smooth the course of international trade.

(v) It will also correct adverse balances of payments where, and when the need for such a correction arises. Each country joining the Fund will contribute a certain quota towards the common pool

The Fund is different in constitution from the earlier American and British proposals. It is not as ambitious as was the *British Currency Union* plan nor is it as rigid as was *the United* States proposal for the United and Associated Nations Exchange Stabilisation Fund. The latter was marked by absolute inflexibility in exchange rates fixed in terms of gold once and for good. It disallowed use of all exchange controls even in the interim period.

Not so, of course, with the I. M. F. The exchange rates can be altered within a margin of 20% without the Fund's assent and further 10% with the assent of the Fund. Also, a country wishing to maintain exchange control for a certain specified period with a view to preventing any serious dislocation to its economy, can do so without much hitch or hesitation If even after this period, the country is not inclined to abandon its exchange control, it is possible it might be granted its choice, provided the Fund is satisfied that such a grant is essential in the interestes of the country concerned. The use of exchange controls can be permitted also in cases where the demand of a country for the currency of another country has become so great that the

Fund, or for the matter of that, the country whose currency is being demanded, cannot meet it.

Thus, though the gold standard still presists it does so in a new form, characterised by flexibility and a certain degree of freedom in working acording to national interests. Earlier proposals had left no room for such a working.

Should India hope to benefit by associating herself with it or is it that she will lose ? An authoritative section of the Indian economists is of opinion that India has more to gain than to lose by co-operating with the I. M. F. And it cannot be gainsaid that the opinion has much to recommend itself. The immediate concern for India is her own people. And economic policies will have to be formulated in a way that they can frequently be adjusted to the national needs. Being a good deal behind others on the international economic plan, we will in many cases have to make choices that may not be palatable to those ahead of us. Exchange controls, for example, would be definitely disliked by countries whose prosperity is very well founded and who hope to make more gains by free dealings. But India would not eschew the use of exchange controls till the has brought about, at least, so much of rescucitation of her drained economy as is sufficient to give her confidence in taking up those dealings, The concession of using exchange control is a big advantage India hopes to reap by joining the I. M. F.

Another advantage would arise out of the provision for flexibility in exchange rates. For any country having a poor industrial structure, such flexibility has immense benefits to offer. But when the country happens to be possessed not only of a weak industrial machinery but also of an insecure, outdated and undeveloped agriculture such a flexibility becomes doubly advantageous. India's agriculture is backward at present and it is possible situations might arise when her agricultural exports dwindle down so much that unless some depreciation is done to the exchange rate, the difficulty would not easily be got over. The permission to alter exchange rate to the extent of 20% is then another benefit of importance that might accrue to India from the I. M. F.

Apart from all this, there will be the advantage that India would have re-inforced her position on the international plane which till now had been made inaccessible to her for obvious political and economic reasons.

The handicaps India will suffer from joining the I. M. F. are not many. But this is not to say that there will be none of

them. As pointed out above, the allocation of dollar quotas to the weaker countries has not been quite fair. And to India it has been particularly so India's quota in the Fund is four hundred millon dollars and she is entitled to draw up to 25% of her quota in a year Four hundred million dollars are a poor allotment to a country with such huge natural resources and manpower and such great possibilities of economic advancement India's quota should not in any case be less than is commensurate with the area of the country and the size of the population

Moreover, a small quota makes India weak in the Fund executive Other countries can easily ride roughshod over India's demands One might feel that the distribution of authority in the executive of the Fund leaves vast masses of backward peoples at the mercy of a few small nations

The I M. F. has been rightly attacked on the count that it makes no settlement of the sterling debts But despite all this India should look to the future of her association with the I M F with confidence and optimism.

PART X

Public Finance

CHAPTER XLIX
PRINCIPLES OF PUBLIC FINANCE

Public finance has been defined as that branch of Economics which studies the income and expenditure of public authorities and the adjustment of one to the other For the purpose of our study public authorities include all grades of governments from the national and international to the provincial and local ones such as municipalities, district boards and even village councils The term finance means the management of revenue and expenditure of any kind, and public finance therefore, refers to such activities of our governments

Public finance is as old as human society, but it is only in recent times that there has been a proper appreciation of the importance of its subject matter and systematic studies have been made to determine its nature and scope This comparative neglect of the subject in the past was due to the restricted field of state activities and the unsatisfactory way in which the finances were managed As a result of this people thought that it was incapable of doing any good except that of providing the defence of society which was the main function of the government It was considered best for the government, therefore, to restrict its activities merely to the political field and spend as little money as possible on other activities At that stage the only important consideration was to keep the burden of taxation as low as possible Moreover, it was desired to distribute this burden as fairly as possible For this purpose the principle of ability to pay' was discussed This was later enlarged into that of the least aggregate sacrifice' But things are different now and our attitude towards the scope of state activities and public finance has undergone a considerable change The growing complexity of life in modern times and the conflict of interests in various spheres have forced the state to intervene more and more in social and economic fields and to take up an increasing number of functions This increased scope of state activities has meant a tremendous increase in public expenditure for meeting which people have to part with a large part of their income It has therefore, become apparent that it would not do merely to consider revenue Revenue and expenditure have to be considered together The money which the state spends is for the benefit of the people

The object of government policy now is not 'least aggregate sacrifice' but 'maximum social advantage'. This means that a mere distinction of the burden of taxes fairly would not do. We have to consider the burden of taxes along with the benefits of expenditure and the sum total of these is the net advantage which people get from public revenue and expenditure. It is this which the state should maximise. In recent years there has been a further change in this principle. Now it is not only the maximisation of social advantage for one budget year but for a number of years put together that is emphasised. This leads to 'planning' of public finance. In this, since it covers a considerable number of years, the extra budgetary finances are also taken into account. It means that preparing government budgets on orthodox lines in which expenditure is balanced against revenue for each year would not do. The state has to plan for a much greater expenditure than its ordinary annual revenues would justify.

These developments in public finance have led to a remarkable change in our attitude towards state activities. People may decry the increase in expenditure in certain directions and resent paying this or that tax. But we do not believe that it is either possible or desirable for the state to cut down its expenditure in every direction merely for the sake of saving the people from paying the taxes. Most of these expenditures, if not all, we realise, are of distinct advantage to the people as a whole and whatever loss in satisfaction is sustained by the people in paying the taxes may be more than compensated by the benefits conferred on them by the public expenditure. Healthy social life, or what is called social welfare which is the object of all social organisations is not possible for people to secure without the active participation of the state with its manifold expenditure in social and economic spheres.

But this does not mean that every public expenditure is good and there can be no limit to it or every method of raising revenue is justified. Government, like the individuals, can, in many cases, waste its resources through extravagance and unnecessary expenditures. Such expenditures are undesirable and should be avoided, because the money can be better utilised by the individuals if it is left with them. On the other hand one particular method of raising revenue might mean a greater loss of welfare to the people as a whole than another. The test of sound finance, therefore, lies not in the amount of expenditure incurred by a government nor the amount of revenue raised by it in the discharge of its duties but in the methods of

doing them and in the net benefit enjoyed by the people from the operation of state finances

Public finance has been classified into (a) Public Expenditure (b) Public Revenue (c) Public Debts and (d) Administration

Public Expenditure studies the range of duties and functions performed by the public authorities and the expenditure during the course of such performance

Public Revenue which forms the necessary counterpart of public expenditure, deals with the manner in which public authorities get their income and the various problems connected with it

Public Debt deals with the use of credit by public authorities and the special problems created by it

Administration treats of the activities of the governmental machinery that is entrusted with the management of finances.

CHAPTER L
PUBLIC REVENUE

In order to perform their functions public authorities, like individuals need income or revenue. The amount of revenue needed by a Government depends on the nature and extent of functions performed by it. In modern times, with the increase in the nature and scope of state activities, governments need an ever increasing amount of revenue and have to tap all available sources to discharge their obligations successfully. The sources of public revenue have been classified in different ways by different writers. This difference is not due so much to a fundamental difference in the subject matter as to the difference in their approach and the historical peculiarities of the place they live in. We shall take a few of these classifications for our consideration. Adam Smith says that there are only two principal sources of public revenue. One, revenue from sovereign's possessions such as land or capital and two, income from the possession of wealth of the people—by which he meant taxation. Revenue from the first source, he thought, can neither be steady nor adequate. So the state has to depend for the major part of its income on taxation.

Seligman divides public revenue into 3 classes: (1) Gratuitous (2) Contractual and (3) Compulsory. The first class comprises free gifts to the state, the second the commercial revenues that arise as the result of contractual relations between the government and the citizen and the third embraces the receipts that are obtained through the exercise of sovereignty in such ways as eminent domain, the penal power, the taxing power and the police power.

Lutz makes the following classification: (1) Commercial revenues (2) Administrative and miscellaneous revenues (3) Taxation (4) Public Loans (5) Subventions and grants (6) Book-keeping revenues or transfers. Mr. J. K. Mehta classifies public revenue into (1) Taxes (2) Fees (3) Duties and (4) Miscellaneous sources such as gifts, fines special assessments etc. It is obvious from these classifications that the most important distinction that can be made is between revenue from taxes and non-tax sources. Some writers have included voluntary public loans as a source of revenue. But this is a mistake, because money

raised through loans has to be paid off ultimately and has to come from other sources available to the state.

A tax has been defined as a compulsory contribution from a person to the government to meet the expenses incurred in the common interest of all, without reference to special benefits conferred. The distinctive features of a tax are, therefore, that (1) it is a compulsory payment, (2) it is for the common benefit and, lastly (3) the payment made by an individual is in no way related to the benefits enjoyed by him from the state expenditure.

Those charges made by the state which do not fulfill all these conditions are non-tax revenue and they include such charges as fees, duties, fines, gifts, etc. A fee has been defined as a payment by a person to the government either for a special benefit received from the government or for a special cost imposed upon the government in connection with a government service performed for the common benefit. The most important feature of this payment is that it is not compulsory and those who pay the charges derive some special benefit which may be in proportion to the payments they make. According to this concept of fees they include all such payments as some writers call commercial revenues, industrial earnings or price and administrative revenues. Fees need not be related to the cost of performing those services for which they are paid even if such calculations were possible. They may be more or less than the cost of the service.

Duties have been defined as those special charges levied on individuals in order to discourage them from consuming those commodities or services whose unrestricted use is believed to be inimical to social welfare. These charges are generally levied on the consumption of harmful drugs and intoxicants. Thus duties are like fees; they are not compulsory and are levied in proportion to consumption. But the distinction between them is one of object of these charges; fees are charged to restrain the consumption of goods and services not because they are harmful but in the absence of any such charges they may be used to uneconomic extent leading to a great wastage of national resources.

Fines are compulsory contributions from a person to the state exacted with the object of deterring people from committing certain acts.

Of the various sources of public revenue taxes are the most important. They produce the largest part of the public

revenue and by their very nature raise some of the most complicated problems of public finance.

Principles of taxation.

In studying the principles of taxation we are faced with such problems as, what is the real purpose and justification of taxation, how much taxes are to be raised by the state and how should the total burden of taxes be distributed amongst the people.

Answers to these questions raise a host of difficulties. These difficulties are inherent in the very nature of taxation.

The problems of taxation raise issues which are not only economic in nature in the commonly accepted sense of the term ; political and ethical issues are also involved along with them. The principle of taxation should take all these issues into account and present the decision as a systematic whole. From the days of Adam Smith various theories have been put forward to explain the nature and purpose of taxation. But most of these theories are, however, unsatisfactory. This is due to the fact that they do not look at the problems of revenue in their entirety. Before we study what is called the fundamental principle of taxation it will be useful to take into account some of these theories.

The first is "Financial" Theory : According to this theory a tax is regarded as being nothing more than a means of providing revenue to the state. It does not take into account the objects of the expenditure for which this money is raised or how the burden of the tax is distributed. It is merely a device for raising money with the least possible resistance from the taxpayers.

The "Benefit" Theory : According to this theory a tax is regarded as a payment for and the measure of a service rendered by the state. This means that those who get the greatest amount of benefit from state activities should pay the highest amount of tax—a position which is impossible and runs counter to the end of the state.

The "Socio-political" Theory : According to this theory the tax is regarded as a distinct instrument in the hands of the state and should be used for the attainment of various political or social ends such as the reduction of inequality of incomes, or encouraging certain industries. It is true that in modern society the instrument of tax is used for many social and political ends and that this theory is more comprehensive than the

"financial" or "benefit" theories but it is rather vague and indefinite

Ultimately we come to the theory which is accepted now a days more or less universally as the fundamental principle of taxation This principle treats public finance as a whole and emanates from the end or objective of the state The end of the state is the welfare of its citizens In the field of public finance in order to create this welfare for its citizens the state has to undertake various activities for which use funds or resources is necessary The creations of public welfare is thus dependent on the expenditure of funds which have as their counterpart in public revenue "Revenue is the means while public good is the end The state, therefore, strives to undertake all these activities which are calculated to increase social welfare In the modern economic order, these activities are best performed through the medium of money, that is, there is the raising of public revenues and then the use of the same in the performance of services or the undertaking of functions that are beneficial to society Thus there is taxation, or more comprehensively revenue preceding public expenditure The latter secures some good for the community while the former, by itself, inflicts a loss If the net result is an increase of welfare the whole state activity is justified The sacrifices inflicted by raising of revenue must be more than counter-balanced by the good done by public expenditure" (Mr J K Mehta) The purpose of taxation is therefore to provide the state with the money which it uses to increase the welfare of its people and if the state succeeds in this purpose the taxation is justified

The extent to which taxation can be pushed up is dependent on how the money is raised and how it is spent Taxation by itself means sacrifice on the part of the taxpayers whereas expenditure of the money raised by taxation means gain in satisfaction Taxation should therefore, be pushed up to that point where the marginal social sacrifice or loss in satisfaction in providing the revenue is just equal to the marginal gain in social satisfaction from these expenditures So long as the marginal social sacrifice providing taxation is less than the marginal gain in social satisfacation from the expenditure of the revenue there is a net gain in increasing taxation But when the point of equality between marginal social sacrifice and marginal gain in social satisfaction has reached, taxation should not be pushed any further

Distribution of tax burden We have seen that in the operation of public finance the loss in satisfaction sustained by the people in paying the taxes is more than compensated by the gain in

satisfaction for the society as a whole from the public expenditure. If society were composed of homogenous units and if everybody were equally benefitted from public expenditure there would have been no problem of the distribution of tax burden. But this problem arises because society is composed of heterogenous elements and those who pay the taxes cannot trace any connection between the amount they are compelled to pay and the benefit they get from state services provided out of the taxes. The problem is therefore how to allocate the taxes amongst the different individuals so that they may be socially just or equitable. There different principles have been put forward for the allocation of taxes. These are : (1) the cost to the public authority of services rendered to individual taxpayers. (2) benefit to individual taxpayers of such services, (3) individual 'ability to pay' taxation.

So far as the "cost of service" theory is concerned it is difficult first of all to estimate the cost of a certain service to a particular individual and secondly this is highly undesirable because this will mean that the state services will be performed for those who can bear the cost and others who may need these services most will have to go without them if they cannot pay the cost. Fees may be based on this principle but not taxes.

So far as "benefit" principle is concerned we have already seen that also cannot serve as a basis of taxation. For purposes of fees and special assessments this principle may be taken into account but not for general taxes.

(3) "Ability to pay" principle which is also called "faculty" theory is widely accepted as the most equitable way of distributing the tax burden. According to this theory every citizen should contribute in proportion to his ability. The theory appears very plausible from the point of view of equity but the difficulty arises about its measurement. Ability has been interpreted both from the subjective and objective points of view. The subjective interpretation refers to the "sacrifice" that the payment of taxes inflicts on the taxpayers, whereas objective interpretation refers to income or possession of wealth or any such criterion. From the standpoint of sacrifice three schemes of the distribution of tax burden have been advanced. These are equal sacrifice, proportional sacrifice and minimum or least aggregate sacrifice. The principle of equal sacrifice states that the money burden of taxation be so distributed that the real burden on all tax payers is equal. According to the principle of proportional sacrifice the burden bears the same ratio to all incomes. And the principle of minimum sacrifice states that the taxes

should be so arranged that the burden on the taxpayers as a whole is as small as possible. The first two principles would make everybody, whether rich or poor, pay something in taxation while the third principle may absolve the poorer section from paying any taxes.

Dr Dalton says, "*Prima facie*, it is not clear on grounds of equity, which of these is to be preferred." But judged from the point of view of the object of public finance the preference is for the minimum or least aggregate sacrifice because maximum social welfare, the object of public finance, is attained only then when the sacrifice consequent upon taxation is minimum.

In order to make the application of any of these principles possible for the purpose of taxation taxes should be related somehow or the other with the objective measure of ability for which generally the income of the taxpayer is taken as the index. This can be done, although rather very roughly, by discovering how the tax-rate should vary under the different principles of sacrifice. From the stand-point of rate-structure taxes may be proportional, progressive or regressive.

A tax is proportional when the same rate is charged for different amounts of income that is taxed or the rate does not change with rise in income. This means all taxpayers contribute the same proportion of their incomes.

A progressive tax is that under which the rate of tax increases or progresses with the rise in income. That is the larger a taxpayer's income, the larger the proportion which he contributes.

A tax is regressive when the tax-rate diminishes as the taxpayer's income rises; under this scheme, the larger the taxpayer's income, the smaller the proportion which he contributes.

The following table illustrates the difference between proportional, progressive and regressive taxation.

	Proportional		Progressive		Regressive	
Income Rs.	Rate per cent	Amount Rs.	Rate per cent	Amount Rs.	Rate per cent	Amount Rs.
3000	5	150	5	150	5	150
5000	5	250	6	300	4	200
8000	5	400	7	560	3	240
15,000	5	700	9	1350	2	300
25,000	5	1250	12	3000	1	250

According to the law of diminishing ulility, the marginal utility of income diminishes as its size increases. On the basis of this law we can say that a tax of 20 per cent taken from a person A with an income of Rs. 1000 will mean a greater sacrifice to him than what it will be to B with an income of Rs. 10,000. So if there is to be equality of sacrifice between A and B B should contribute more than 20 per cent of his income. This means therefore, the principle of equal sacrifice leads to progressive taxation. Consequently, the principle of proportional sacrifice leads to still steeper progressive taxation. The principle of minimum sacrifice will result in the exemption of people with income below a certain level and a very steeply progressive taxation of those whose incomes are above the exemption limit. That is so because amongst people with different levels of income a certain amount of tax to a person with a lower income causes a greater sacrifice than to another with higher income. It is to be noted in this connection that, first the conclusions about progressive taxation are based on the assumption that the relation between income and economic welfare is the same for all tax payers. This means that individuals in the same economic position derive the same benefit from spending equal doses of their income. Similarly they suffer the same sacrifice if their income is reduced in equal doses by taxation. The validity of these assumptions has been challenged. But it can be said in their defence that no absolute rigidity is claimed on their behalf; they are mere approximations and are true to that extent. Secondy the principle of minimum aggregate sacrifice does not indicate what should be the exemption limit or the steepness of progression. They are all fixed arbitrarily. But in fixing up the exemption limit, the governments generally take into account the amount of income which is essential for the minimum subsistence of the people, from the standpoints of health and efficiency.

Whatever disagreement there may be about the theoretical exactness of these principles, progression and minimum aggregate sacrifice have been accepted by all modern governments as instruments of practical policy in determining the rate-structure of their income tax systems. Thus, for example, the Government of India for the purpose of the income-tax (1) exempts all incomes below Rs. 3000 (2) taxes at the rate of -/15/6 including super-tax every rupee of income at the level of Rs. 3.5 lacs and above; (3) applies the progressive rate on incomes between these two levels. This can be illustrated as follows: modern governments employ various taxes to earn their tax revenue and although progressive taxation is regarded as the most equitable,

so far as equity is possible, it is only in the case of the income tax that this principle is applied So far as other taxes are concerned, which we will consider presently, they may be both proportional and regressive and may not conform to the principle of equity But in judging the tax structure of a country we have to take into account the tax system composed of different taxes as a whole Individually some taxes may be progressive but due to other taxes the system as a whole may be regressive and inequitable Similarly a few taxes may be regressive but others may be progressive and on the balance the whole system may be equitable

Although all taxes are ultimately borne by individuals who pay them either out of their income or property, for the purpose of administrative convenience governments adopt various devices to collect their tax revenues by basing the taxes on different classes of objects The adoption of some such devices not only makes the tax system complicated but often adversely affects individuals who may be entirely unaware of it and may produce effects on the economic structure of society not intended by the framer of the taxes It is the purpose of tax analysis to investigate how different taxes affect different individuals, both directly and indirectly and what ultimate effects the taxes have on the economic organisation of society This is done by classifying taxes into different categories and studying their incidence and effects Taxes have been classified in various ways But the most important one is to classify them into direct and indirect taxes Direct taxes have been defined as those taxes which are intended to be borne by the persons on whom they are levied, while indirect taxes are levied on one set of persons in the expectation and with the intention that they will be passed on to others by the process of shifting " *

That is, in case of a direct tax both the impact and incidence are expected to be on the same person but in case of an indirect tax they are expected to be on different persons Income tax and inheritance tax are examples of direct taxes and excise duties and custom duties are examples of indirect taxes But this is only broadly true and no rigid distinction can be made because there may be cases where part of the incidence of indirect tax cannot be shifted, whereas there may be also cases when a part of the incidence of the direct tax can be shifted

Before we can appreciate properly the role played by these taxes it will be helpful to ascertain the meaning and significance of the terms used in tax analysis, such as impact, incidence and effect of taxes These terms refer to the stages through which

* *Vide*, Lutz, 'Public Finance'

a tax passes from its announcement to final resting place and the different reactions it produced. These reactions are not confined merely to the persons who are concerned in providing the money but also spread over the wider field of the economic structure and organisation of society.

The term impact refers to the reaction which the prospect or idea (or fear ?) of parting with money and thereby bearing the burden produces on the person called upon to pay a tax. By incidence is meant the final resting place of the burden and is said to be upon the person who ultimately pays the tax; whereas by the effects of a tax are meant the sum total of changes produced on the economic life and structure of the society as a result of the tax. Although it is quite obvious that in judging a particular tax or a tax-system we have to take into account all these aspects yet for the purpose of tax analysis it is necessary to distinguish one aspect from the other and study them separately. It has been suggested that it is not possible to separate one aspect from the other because in practice they are intermixed. This may be true from the practical point of view but for distributing the tax burden equitably it is essential to keep such a distinction in mind.

Persons on whom taxes are imposed or from whom they are collected need not necessarily bear the burden if they can afford to pass it over to some one else. This is done by what is called the process of shifting . This does not mean that all taxes can be shifted by those on whom they are imposed, neither can those taxes which are shifted be done so to the same extent or degree under every condition.

But it is possible to imagine that under certain conditions the incidence of a certain tax can be separated from its impact. The difference between direct and indirect taxes is based on this distinction. The process of shifting makes the equitable distribution of tax burden rather difficult and complicated. It is obvious that taxes should be distributed according to the ability of those on whom the incidence is likely to fall rather than of those from whom they are collected or on whom they are imposed. It is necessary, therefore, to discover the conditions under which taxes are liable to be shifted so that the tax burden may be adjusted accordingly. This gives special importance to the theory of shifting and incidence of taxtion.

Taxes are shifted as a result of some kind of price transaction or buying and selling between two persons. If the person from whom the tax is collected can obtain a higher price for his product, he succeeds in shifting the tax to the buyer. Taxes

may be shifted both forward and backward. In practice we find them generally shifted forward from the producer to the whole saler, from the whole saler to the retailer, and from the retailer to the consumer It is only in rare cases that they are shifted backward from the retailer to the wholesaler, or from the wholesaler to the producer and even from the producer to those who supply some particular factor of production. But in whatever direction it is shifted it mostly follows the line of least resistance. We have said that taxes are generally shifted by raising the prices of the commodities which enter into exchange. The best way, therefore, to study the theory of incidence and shifting of taxes is to analyse the manner in which a tax on commodities affects their prices. The degree and character of shifting of a tax is determined by the effects it produces on the prices of the commodities. Prices, under normal conditions, are determined by the interaction of the forces of demand and supply. Prices of a commodity, therefore, can be affected normally either by influencing the forces of supply or of demand or of both. Sellers try to shift the tax by raising the price of the commodity through their control over the forces of supply. Buyers, on the other hand, resist it by their control over the forces of demand. The degree and character of shifting will depend on the respective bargaining powers of the different parties. Without going into the details of the various complex forms of shifting and incidence under different conditions we shall concern ourselves with some broad generalisations that can be made about them At the outest it is necessary to make clear distinction between taxes on commodities and services or indirect taxes on the one hand, and taxes on income and economic surplus or direct taxes on the other. As regards the shifting and incidence of taxes on commodities and services are concerned they are determined by the elasticity of demand and supply of these commodities. It has been said that other things being equal, the more elastic the demand for the object of taxation, the more will be the incidence of the tax upon the seller. Whereas, other things being equal, the more elastic the supply of the object of taxation, the more will the incidence of the tax be upon the buyers. In case of very elastic demand for the taxed commodity buyers will try to resist any attempt at price increase by threatening to reduce their purchase. If the tax rate is not very high sellers will grudgingly bear the incidence rather than risk a big decline in their sale. On the other hand if the supply is very elastic the sellers are in stronger position. They will shift as much of the tax as possible by threatening to reduce the supply and the buyers will be forced to yield. Elasticity is a relative term and it is very seldom we come across

a commodity which has an absolutey in elastic demand. But generally speaking the demand for luxuries is more elastic than the demand for necessaries. It follows from this that a tax on luxuries is less likely to be shifted than a tax on necessaries. This means, therefore, that, other things being equal, a tax on necessaries will raise their price by a larger amount than an equal tax on luxuries. Absolute inelasticity of suppply is also very rare. But there are certain commodites, like land in well populated locality, whose supply is much less elastic, both in the short and long runs, than many other commodities. Therefore, a tax on commodities like land can be much less shifted—if it can be shifted at all—than an equal amount of tax levied on commodities whose supply is more elastic. There are a few important points to be noted about the elasticity of supply. First is the element of time. Supply may be inelastic in the short period but elastic in the long run. In the short run supply of a commodity may be inelastic, because a new tax may be imposed not anticipated by the producers and when a stock has already been accumulated. If the goods are not of a very durable nature the producers will be forced to dispose of their stock even at the cost of the whole tax, but will regulate subsequent production thereby controlling future supply. Secondly, in comparatively short period, supply of goods, for the production of which expensive and specialised machinery and highly skilled labour are used, may be inelastic. Producers will find that to cut down production with the imposition of a tax will mean keeping the machinery partially idle, the loss of which may outweigh the amount of the tax. Moreover, they may shift a part of the tax to the skilled labourers, whose position will be weaker now, because if production is cut down some of them will be either partially employed or unemployed. For some time, therefore, producers will maintain production and bear the incidence themselves or share a part of it with the labourers or with those who supply the raw materials and whose position may be vulnerable like that of the skilled labourers. But, in the long run, they will adjust supply by restricting the replacements of machinery and investment of new capital, thereby making the supply elastic.

Shifting and incidence are also affected by the conditions of supply which may be either competitive or monopolistic. There may be cases where a monopolist is not able to shift a tax on his product or may be able to shift a part of it, whereas the same tax levied on goods produced under competitive conditions may be entirely shifted. There may be also conditions where just the reverse is true. That is a monopolist may be

able to shift the entire incidence of a tax and the competitive producer may be prevented from doing so

Direct taxes such as income tax, and death duties and taxes on economic surplus like a tax on economic rent are more difficult to shift and consequently their incidence is to a great extent on the party on which they are imposed

The theories of shifting and incidence indicate that it is only in the case of direct taxes—where the incidence cannot be shifted—that the tax burden can be equitably distributed and be made progressive If any state collects a large amount of its revenue through indirect taxes it does so by taxing the "necessaries"—commodities consumed by the mass of the people Such taxes weigh more heavily on the poor and are regressive in character From the standpoint of equity, it follows, therefore, that if a state cannot entirely abolish indirect taxes from its scheme of taxation it should have as few of them as possible and under normal conditions they should not be on what are called "necessaries" of life

Effects of taxation Taxes produce different kinds of reactions on the economic life and structure of society These reactions or the effects, as they are called, can be either good or harmful It should be the object of all taxations to avoid completely or to minimise as far as possible the harmful effects "The best system of taxation from the economic point of view" as Dr Dalton puts it "is that which has the best or the least bad economic effects" But it should be emphasised again that in judging a tax system from any point of view the effects of the corresponding expenditure incurred from the proceeds of the taxes should also be considered If the harmful effects of the tax system outweigh the net social advantages gained from the state finances then it is to be concluded that the state has failed to realise the objective—maximum social welfare—from the operation of its finances

The effects of taxes will be harmful if they check the production of wealth or impair the growth of national dividend and obstruct equitable distribution of what is produced Production will be checked if the tax system impairs the health and efficiency of the people and discourages savings and investments Thus any taxation upon the poorer members of society, whether direct taxes on small incomes or taxes on necessaries, will be undesirable Because such taxes will cut down further the incomes which may not be sufficient or may be just so for the barest subsistence of life Steeply progressive tax rates which knock down large incomes have been objected to by many writers They think that such taxes hinder the will to work

and to amass large incomes and impair the incentives to risk-taking. High taxes would certainly be undesirable if these were to be their outcome. But the will to work and the incentive for risk-taking are the resultants of large and complex forces of which pecuniary motive is just one. So a progressive tax rate merely by itself need not always produce such harmful effects as have been feared. Moreover, public expenditure of the tax proceeds, if judiciously undertaken, can off-set greatly the adverse effects that taxation may have on savings and investments. The principle of progression in taxation has been accepted by tax payers all over the world.

We have studied taxation in all its important aspects. We finish our study by summing up what may be considered as the main characteristics of a well-designed tax system:

(1) Fiscal Adequacy. A tax system should provide the state with adequate and dependable revenue.

(2) Equity. It should be fair and equitable.

(3) Economy. This does not mean merely that the cost of collection should not be unduly high but what is more important it should not adversely affect the ecomomy of the nation.

(4) Elasticity. The tax system should in times of emergency be capable of producing increased revenue without undue disturbance to the economic life of the people.

These characteristics, as will be obvious, are closely interrelated.

CHAPTER LI

PUBLIC EXPENDITURE

Although it is expenditure and not income that is the governing factor in public finance, economists, notably English writers have had little to say about its principles. The reasons are not far to seek. The English classical economists who propogated the *laissez faire* principle maintained that state intervention and consequently state expenditure must be kept at a minimum.[1] This doctrine of limited governmental activity dominated English and American writing on public finance until recent years. But the march of events contradicted this conservative doctrine which had to be altered under pressure of necessity or expediency. And as a result of the primary function of civil and military protection and civil administration such social activities as education, the building and maintenance of roads also began to be provided for.

The scope of governmental activity and hence of expenditure has increased with increased consciousness and the need to reduce the evils of individualistic system has grown.[2] It was felt not only necessary to protect the society from external and internal troubles, but also to improve the quality of people, a large majority of whom are under-privileged, by expanding the scope of state and

1 "The very best of all plans of finance is to spend little and the best of all taxes is that which is least in amount" J B Say

2 Total State Expenditure as a percentage of total National Income

	1929	1932	1933	1936	1937	1938
	%	%	%	%	%	%
Canada	7	14	14	13	.	..
United States	4	8 5	12	13	11	15
Japan	15	19	20	17		(42-43)
Belgium	18*	23		21	20	.
France	19	26	28	29 5		(28
Germany	11	13	13	.	.	.
Hungry	25	30	32	33	31	28
Norway	16	18	17 5	20	19	..
Sweden	10*	15	15	13	.	..
Australia	22	25	29	19	..	..

Great caution should be observed in using these figures for international comparisions of the changes within each country. The figures in brackets ar not strictly comparable. World Economic Survey 1938-39 p 58

local welfare activities.[1] Coming to this generation the care of the sick, the aged poor, and the unemployed has come to be regarded an obligation of society. It is now increasingly recognised that it is the business of the state to ensure that every citizen is able to enjoy the primary necessities of life—sufficient and proper food, adequate shelter and health and education services commensurate with his needs. It is widely held that the state should ensure this minimum by itself buying or producing and distributing the means of satisfying these primary wants, whenever it is apparent that the field is not being adequately covered by private enterprise[2].

At this stage the question that arises is, whether there are economic limits to or possible maxima of governmental expenditure. Schultz answers correctly when he says, "Political philosophy gives no help, economic theory little help in defining the scope of state activity and hence of governmental expenditure. Economists and political theorists are as impartial as munition makers—they supply explosives to both sides of many controversies".[3] Economists may have evaded the question by leaving it unanswered. The issue, however, is clear. The individual has needs and many of them can be most effectively satisfied through the agency of the state, that is, by means of public expenditure. This is realised today more than ever. In the post war years it has become all the more necessary to establish a close relationship between the individual and the state and consequently there has arisen the popular demand for the nationalisation of the key industries in every country of the capitalist world.[4] In this demand is manifest the universal urge for the extension of the state activities.

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1. Public expenditure in America has increased from 7·1 ratio to national income in 1890 to 2.47 in 1940.

Shultz—*American Public Finance*, page 55.

2. U. K. Hicks—*Public Finance*, page 13.
3. W. J. Shultz, *American Public Finance*, page 29.
4. England, the origin of the *laisse faire* theory, has nationalised its Bank of England and coal industry. In their election platform the Labour Party which is in power today promised to nationalise besides, internal transport, power and metallurgical industry.

In Poland all enterprises employing more than 50 workers were taken over by the state according to the decree concerning nationalisation of Polish industry (Jan. 1946). Simultaneously all the big commercial banks were nationalised.

In Ezechoslovakia, on October 24, 1945 by a decree of the President were nationalised the large scale industry, mines and pits, electric power stations, banks and insurance companies—Nationalisation of Industry after the War, by L. Eventoo in *World Economics and World Politics*. No. 4, 1947, translated by A.B. Kharadikar.

Classification of public expenditure Public expenditure has been variously classified by economists and there is no unanimity of opinion among them

Nicholson's classification J S Nicholson who seems to maintain an extremely limited scope for state activity divides expenditure on the basis of revenue received in return for services rendered The ultimate object of public expenditure is not revenue Such a classification may be useful from the point of view of the financial administrator, but it is hardly of any theoretical interest[1]

Plehn's classification Prof C C Plehn classifies expenditure on the basis of benefit rather than that of revenue. This classification has a fundamental basis The distinction, however, between the different classes of benefit cannot be clear-cut as there is likely to be constant shift from one class to another with evolution which Plehn himself admits

Shirras, classification Shirras divides all expenditure into primary and secondary expenditures "Primary expenditures include all expenditures which governments, worthy of the name of governments, are obliged above everything else to undertake, viz defence, law and order and the payment of debts" Such a classification is unsuitable today when a distinction between primary and secondary functions of this kind cannot exist due to the fundamental changes in the views of men regarding the functions of the state

Public expenditure has also been divided into protective, commercial and developmental on the basis of the nature of the economic function performed by the state[2] The division, however, is not clear cut Commercial and developmental expenditures are in a way protective also and even if protective expenditure could be defined, the overlapping of commercial and developmental expenses would be difficult, if not impossible to avoid[3]

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[1] First expend ture without any d rect return by way of revenue, e g poor relief expend ture on war two expenditure without direct return but with ind rect benefit to the revenu e g education , three expenditure with partial return e g educ tion for w ich fees re received, sudsidised railways that pay part of the expense f rth expend ture that obtains a full return e post office ga rks a l generally tate industries

Principles of Political Economy

[2] Adam *Finance* p 1

[3] J K Mehta *The Nature and Classification and Principles of Pu l c Reve ue and Expenditure* p 20

Robinson. According to Robinson expenditure may be productive or unproductive. "Any state expenditure which directly or indirectly develops the natural or human resources of the nation or leads to their more economical use may be expected to increase national prosperity by increasing the national wealth, and may thus be expected ultimately to pay for itself given the important qualification that the gain due to increased expenditure is not less than the loss caused by heavier taxation".[1] This is more a principle which should guide public expenditure than a classification.

Professor A. C. Pigou classifies expenditure into two classes, exhaustive or real or non-transfer expenditure and transfer expenditure, that is "expenditures that purchase current services of productive resources for the use of (government) authorities and expenditures which consist in payments made either gratuitously or in purchase of existing property rights to private persons"[2]. Real expenditure implies the actual using up of resources which would have been otherwise available to the community. Transfer expenditure on the other hand involves not using up but simply transference of resources from one person to another.

Dalton draws a broad distinction between public expenditure intended "to preserve the social life of the community against violent attack whether internal or external", and expenditure intended "to improve the quality of that social life".[3] Another distinction drawn by Dalton is division of expenditure into grants and purchase prices. "An individual who receives pubic money may or may not render in return a direct *quid pro quo* to the public authority." If the individual has rendered services in return for which he receives payment the state makes a purchase from him. On the other hand if he receives public money or money's worth without contributing anything the state makes him a grant. Grant consists either of money or of services

1. M. E. Robinson, *Public Finance*, p. 7.

2. "The former group includes expenditures on the maintenance and building up of the army, navy, air force, civil service, educational service, judiciary, post office, municipal tramway service and so on. The latter includes expenditures on the payment of interest on government debt pension, sickness benefit and unemployment benefit, also subsidies on the production of particular kinds of commodities, sugar, milk, meat or houses; also payment made in the redemption of government debt, i.e. repurchase of government securities"—Pigou,

A study in Public Finance p, 19.

3. H. Dalton, *Public Finance*, p. 201, p. 205.

such as free medical services, or education or old age pensions poor relief contributions from general funds to social insurance schemes Payment by the state to any of its employees or to contractors are purchase prices Dalton compares the distinction between grants and purchase prices with that between transfer expenditure and real expenditure

Mr J K Mehta adopts a classification of constant and variable expenditures Expenditure is constant when it does not necessarily increase with increased use of services which are financed by it e g expenditure on national defence or on light houses This expenditure is not affected by the extent to which the individuals use or choose to be benefited by, the services which are financed by it Expenditure is variable when it increases with every increase in the use of public services by the people for whose benefit they are incurred e g law courts, public undertakings[1]

Thus we find that public expenditure has been subjected to a variety of classifications, most of which are based on certain features of expenditure. In many cases the classes are either overlapping or are not rigid as in Plehn's and Shirras' classifications or the fundamental basis of public expenditure is ignored as for instance when revenue received is made the basis of classification Robinson lays down a useful principle to guide public expenditure While Mehta's definition may have a logical basis Pigou's classification based on the very nature of public expenditure, from this point of view is a very satisfactory one

Principle of public expenditure The doctrine of maximum social advantage is the fundamental principle of public finance Maximisation of social advantage is possible when with the objective in view public expenditure in different directions is pushed in such a way as to yield equal marginal utility To a statesman with an objective standard of social welfare there is the whole wealth of the community to draw upon in addition to the possibility of making loans And since public expenditure is able to bring about change in the wealth of a community

[1] The state decides to spend a certain amount on this head (i e national defence) an amount which is mainly determined by external factors and only partly by the size of the population or the value of the prosperity in the country J K Mehta *The Nature and classification and Principles of Public Finance and Expenditure* p 20

and its distribution, the distribution of a given total of expenditure between different directions should aim at equal marginal utility.

Equalisation of utilities is necessary not only of the present expenditure but also of the future expenditure. This is as true of public finance as of private finance. In fact the responsibility of the public authority is much more as it is the trustee of the future.

Public expenditure and production. Since governmental bodies undertake both exhaustive and transfer expenditures, utilising large sums of money as employer and producer of services and commodities, the production system of a country is certain to be profoundly influenced. Their action and reaction extend through the economic system as a result of diversion of resources, and may cause changes in the character and volume of production. The English economists of the *laissez faire* school ignored the results of governmental expenditure and studied the effects of the reduction of private purchasing power caused by taxation. In the final analysis, public expenditure involves a transfer of purchasing power which is most clearly seen in the cases of old age pensions, social insurance schemes and interest on loans. These give a large section of population additional purchasing power, and often increase their savings. Besides, the expenditure on education and the maintenance of health services are an investment in human resources which has its influence on the total production.

Again as Dr. Dalton points out public expenditure exercises a great influence on production due to the diversion of economic resources that it brings about between different employments and localities. In those countries where public finance or public economy has a much wider scope (because it works along certain planned direction of all economic activities towards definite ends) the extent to which diversion of resources can take place is very great. In the U. S. S. R., the First Five Years' Plan was mainly devoted to diverting resources to promote the growth of heavy industries. The main economic and political purpose of the Five Year Plan of 1946-50 on the other hand is to rehabilitate the war ravaged regions of the country, to restore industry and agriculture to their pre-war level and then to surpass this level considerably".[1] Public expenditure is playing an important part in rebuilding and rehabilitating the countries of eastern

1. N. A. Voznesensky, *Report on the Five Year Plan*, 1946-50.

Europe, which are nationalising their means of production and planning their economic activities as the only solution to their economic problems

Within the framework of private property and private enterprise diversions of economic resources take place within a restricted field, as the range of economic activities of the state is narrow However it has been recognised that all those forms of public expenditure which increase productive efficiency more than it would increase if the funds were left in the hands of private individuals are justified To this class belongs expenditure on railways irrigation, afforestation and reclamation of land, second research and invention and third, maintenance of public utility services education, public health, and aid to insurance against unemployment and other risks

Diversions of economic resources take place between localities when the central government makes a distribution of grant to local authorities without which they cannot function properly Areas economically undeveloped require such financial aid

Resources may be diverted to unprofitable and unproductive ends also A large part of public expenditure today is diverted to the making of armaments and maintenance of military services, expenditure which does not add anything to human welfare An increase in the expenditure of the armed forces by all nations does not increase the relative security of a government, it takes away economic resources from other uses in which they would have made a direct contribution to human welfare The community is deprived of the services of a large number of selected and also large quantities of important commodities such as iron coal and oil and economic welfare is reduced To this class would also belong expenditure on domestic police, courts of justice factory inspectors expenditures which make no positive contribution to human welfare [1]

Thus a wise system of public expenditure will stimulate production by increasing productive efficiency of the people as a whole, and by diverting resources to productive channels

Public expenditure has its influence on distribution That system of public expenditure is desirable which tends to reduce gross inequality of incomes A system of public expenditure which

[1] Expenditure which would be largely unnecessary if only men were a little wiser or more imaginative or more honest than they are Dalton *Public Finance* p 215

reduces inequality of incomes instead of enhancing it, contributes to economic welfare. Direct transfer of wealth improves distribution by reducing inequality, and also by adjusting individual incomes to family needs during different periods of time. Provisions of old age and widow pensions and sickness, unemployment and maternity benefits have this as one of the objectives in view. The more usual method of transfer is by the provision of free goods and services as free medical service, free education. The effect of both direct and indirect transfer is reduction of inequality of incomes.

Expenditure which confers common benefit on all members of a community, as provision of good roads or free water supply, cheap transport, undoubtedly influences distribution, but its effects on the different classes are difficult to trace[1].

1. "While paying taxes is an individual affair, about one half of public expenditure goes to provide benefits which are to all intents and purposes indivisible. On the other hand, the other half of public expenditure has a very definite and socially important distribution between income classes, and it is this in which we are interested when we talk about the redistribution of income". U. K. Hicks, *Public Finance*, p. 297.

PART X

Conditions of Economic Progress

CHAPTER LII

EARLIER FORMS OF PRODUCTION

Primitive State

Ever since man was born on this earth he has experimented with varied and diverse methods of earning his livelihood. The necessity of earning daily bread through his direct, personal effort was so pressing that at no time could he shake off his bondage to the world around him. Many a time, in the course of his long and arduous journey to civilised forms of life, it was vainly sought to emphasise that man by no means lived by bread alone; but the circumstances of life every time made him realise that he could not also live wthout it for long. Thus, almost unaffected and unaltered by all that he could conceive to lighten his routine toil, involved in earning daily bread, his slavery to Nature continued.

In the earliest phase of his life on this earth he had to depend for his livelihood on those things around him on which he could easily lay his hands. Living in jungles and on hills, for then the earth's surface mostly abounded in these, he had to pluck fruits and kill animals to satisfy his hunger. In that state, it is believed, he lived long, when he learnt the use of the skin and bones of the animals he hunted on. And after the discovery of fire he also learnt how to cook his food. The fat that he got from the animals he began to use now for lighting and cooking purposes.

Although man was only one of the myriad living beings inhabiting this planet, yet in the method and manner of living he soon distinguished himself from other animals. While the latter invariably accepted life as they found it, man was never contented with his lot. It was mainly for this reason that in the long course of his evolution he seldom took anything as unalterable or unchangeable. On the contrary, he was constantly changing his environment and transforming the quality of his life with a view to produce better results. For instance, while animals continued to live in the same state in which their earliest ancestors had lived on this earth, man began, stage after stage, to cook and store food, cover himself with animal hair and skin, hollow out caves for taking shelter, and make tools and implements to increase his supply of food. He was, in fact,

in a perpetual state of restlessness in the pursuit of ease, comfort, protection and, above all, security in life.

It was this untiring effort of man to provide security which led him to effect some of the greatest transformations in the quality of his life. For example, when he found that he could not always be sure of catching fish or killing animals just in the hour of his need, he became painfully conscious of the uncertain and precarious nature of his earthly existence. But since he was not one who would easily accept defeat, he now decided to domesticate the wild animals, instead of killing them when he felt hungry This decision of his had far-reaching influence on the subsequent course of his economic evolution

Like this, now, he came to depend for his livelihood on a fully secured supply of animal food provided by the domesticated cattle from which, it may be noted, also followed some additional gains For example, he could get from these animals not only meat, fat, skin and bones, but also such rarities as milk, butter, cheese, etc. Domesticated cattle, however, required expansive grass lands to be used as grazing ground. Hence the earth's surface now began to be parcelled out in clearly demarcated units, each belonging to one or another group of individuals, to be used for growing grass for feeding the cattle.

The Agricultural Stage

Convenience and civilisation in human history have been closely associated with each other. As men succeeded in making their lives more comfortable they came to be recognised as more civilised. And, therefore, all those factors which go to make life comfortable and easy are also regarded civilising factors in human history. But comfort does not only consist in doing a job without much bodily discomfort. Rather, the term is to be understood in a much wider sense, which would include consideration of all those factors which ordinarily go to make life a pleasant and joyous experience.

It was this insatiable desire of man for comfort and convenience which led him to agricultural activity. When exactly and in what part of the world it was first decided to scratch the earth's surface for raising food, are questions shrouded in obscure history. It is probable that just chance discovery of grain-bearing plants excited and spurred man's imagination to take to the ploughing of fields for the cultivation of such plants. When earlier men had not remained contended with

other chance mercies of Nature for their fare, they could hardly bear the insecurity inherent in a livelihood which was to depend on the day-to-day search of grain-bearing plants. It was for this reason, therefore, that men decided to create their own conditions for the cultivation and culture of such plants. And once this activity became popular in one part of the world, slowly and gradually it spread to other parts, by the two-fold processes of transport and transplantation of plants.

Thus human society came to subsist on a type of mixed farming in which men, cattle, ploughs, plants, manure and the rest played their different parts to produce abundant supplies of grain, milk, meat, fruits, etc. for human consumption. It may also be noted that animals were now used not so much for the purposes of direct consumption as instruments of production. In fact, their usefulness had come to be recognised primarily as beasts of burden and as a source of power. For not only were they being used for carrying things from one place to another, but they were also utilised for drawing the plough to make agriculture possible.

Development of agriculture, however, instead of meeting man's many requirements or solving most of his problems, only created fresh wants and caused new problems. Far from being content with abundant supplies of food and satisfied with relative conditions of ease and leisure, he proceeded to think of fresh devices to provide himself with even more goods and services than he had hitherto enjoyed.

The Feudal Period

Thus we find that the satisfaction of one want, in fact, only led to the creation of another, and the manufacture of one commodity just opened the way for the manufacture of another. Human society advanced on this familiar pattern, grew in numbers and multiplied with every return of the calendar year, so much so that when we open that chapter of history which is known as the medieval period we find considerable parts of the earth's surface more or less inhabited. Men were at that time engaged mostly in agricultural activity of one sort or another ; some were exclusively occupied in the manufacture of finished commodities ; a good number of others were devoting all their time and energy to the transport of raw and finished materials from one place to another. Apart from these, there were also some who, instead of directly producing or transporting goods, were busy looking after the affairs of men generally, for which

they recived regular payment, apart from exercising almost unlimited authority on other members of the society

Throughout the middle ages the basis of life was more or less of this pattern, in which agricultural activity occupied the most important place There were extensive tracts of land owned by individual farmers, who cultivated them with the object of producing enough grains for the requirements of their families Whatever was left over was sold, and with a part of the cash thus obtained other necessary commodities, produced by other members of the community, were purchased in the market of the village or of the town Out of the same cash rent was paid to the feudal lord, tax to the servants of the State and tithe to the parish church The savings, if any, were set apart and put away for the rainy day

But even those who were mainly engaged in agricultural activity produced in their spare time goods of other sorts too They produced these other goods primarily with a view to meet their families, requirements in respect of these goods In other words, every agriculturist, apart from growing crops on his field, also took part in some sort of side activity in order to fill his spare time with work to earn something extra in kind or in cash

Next in order of importance to these were the people who devoted all their time and energy to the manufacture of goods They took part in such non agricultural activity mainly with the object of selling their produce in the market and thus satisfying their wants And if, apart from this, they were also interested in agriculture then that interest was only of a subsidiary nature Their main occupation, in other words, was manufacture of commodities, either with their own resources or with those supplied by others The power that was used in such production was provided by the hands of the workers Also the capital and equipment, which they used, as a rule belonged to them Thus these handicraftsmen of the feudal period were, for all practical purposes, their own masters and their own servants But there were also some who worked with borrowed capital and equipment People who had become very prosperous or those who enjoyed exceptional privileges of possessing very high degree of skill employed these workers as assistants to work for them at their premises on regular daily or weekly wage

Manufacture In The Fedual Period

Thus we find that manufacture in the feudal period used to be carried on mostly on one's own premises, in the intimate

atmosphere of the domestic environment. One worked only as much as one thought one could easily work. As there was no pressure from above or from outside, there could be no question of any body over-straining himself. While working one could take as much rest as was necessary in the interest of health or better work. As division of labour had not been taken to any extreme stage, production had not yet become monotonous in nature. And even when paid artisans worked for others, conditions of work were not very different. In such working establishments too there prevailed the same easy and intimate atmosphere of willing, cordial co-operation. The masters, no doubt, thrived on the labour of their servants, but they did so without taking recourse to such methods of merciless exploitation as became associated with production in a subsequent period of economic history.

Subsistence was the *raison d'etre* of production in the feudal period. People produced primarily with the object of satisfying their wants. But from this one need not necessarily conclude that nobody produced any surplus. Such a conclusion would be unwarranted when we have already emphasised before that, while producing to meet day-to-day requirements, every body tried to produce a little more to provide for the rainy day. It was this surplus production, either in cash or in kind, which constituted one's savings. Still the consideration of profit was not the determining factor in production.

When the medieval period of history was drawing to a close, side by side with agriculture and manufacture, commerce had also established itself as a major economic activity in many parts of the world. And it may be noted that as a result of this excellent combination of agriculture, manufacture and commerce there followed a phase of widespread prosperity. But all classes of people did not share in that prosperity equally i.e. while one social group became very rich others' condition did ot improve much. Consequently, in certain social groups, including the ruling class, there came to prevail a great measure of affluence. In the sunshine of that benign prosperity great advance was made in money spheres of civilised life. And it was this factor which led some historians of our own time to conclude that there existed greater contentment and happiness in the feudal times than people could ever have in the capitalist period, which followed the former. There were also some who held the view that in the feudal period there prevailed such a beautiful poise and balance of respon-

sibility and service between the master and the servant, the ruler and the ruled, the clergy and the laity that living in those times was the best of experience

Such a view of history on closer examination would be found to be erroneous. The fallacy inherent in this approach arises from the fact that such people, in effect, are found to be comparing the good points of the feudal society and life with the dismal features of the transitional period, which intervened between Feudalism and Capitalism. But, as one should know, a period of transition is always accompanied with dislocation, unrest, exploitation and misery. This was equally true of the period following Feudalism and preceding Capitalism

Transition from Feudalism to Capitalism

It is commonly believed that every phase of civilisation, after some time, begins to show signs of decay, when it is rejected for something better But while making such a statement its reason is not always stated The obvious explanation of this phenomenon is that when as compared to the existing one a better and more superior mode of production comes to be known, men naturally discard the former basis of life and civilisation, which had been the gift of the older mode of production. This same factor explains the cause of the supersession of the feudal by the capitalist order of society.

Now, we have to distinguish these two preriods in economic history from each other. In the feudal period, as we have seen, the main type of economic activity was agriculture. But in the capitalist period agriculture loses its former place of pre-eminence In the feudal period manufacture was of secondary importance; but under capitalism it becomes the most important means of production In the feudal period power in industrial production was provided mainly by the hands of the workers in production; in the capitalist period it is machine which drives the wheels of production In the feudal times goods were largley produced to satisfy the wants of the producers themselves But in the capitalist period production is carried on by a small number of people mainly with the object of earning profit. Thus, while an average producer in the feudal period was generally both the producer and consumer of the goods which were produced through his agency, in the capitalist period goods are produced through the efforts of some to be consumed by others Like this a gap occurs between production and consumption, which not always leads to the pro-

duction of such goods as are socially most necessary. In other words, when profit becomes the criterion of production sometimes even such commodities are produced as are least necessary for human consumption.

When fundamental and drastic changes of such magnitude occur in economic life, transformation in social inter-relations should become inevitable. And it is this factor which explains why the industrial class in the age of capitalism assumes incomparable importance and enjoys unparallelled power in social and political life. It may be remembered that similar privileges and powers, though on a smaller scale, were enjoyed in the feudal period by the landed aristocracy. Position of advantage or disadvantage occupied in economic life is always reflected in social relationships. This is why at the end of the feudal and the beginning of the capitalist period, when commerce had become nearly as important as agriculture, power and privileges were, for all practical purposes, equally divided between landed aristocracy and commercial capitalists. In fact, it is for this reason that some people prefer to call this period of history as Commercial Capitalism as distinguished from preceding Feudalism and following Industrial Capitalism.

CHAPTER LIII

CAPITALISM

How It Came About

The modern system of industrial production is said to have begun in England, approximately about the middle of the eighteenth century. Some people attribute the fact of England taking lead in industrial movement purely to an accident of history. But on closer examination such a view would be found incorrect. No doubt it would seem strange that some of the most important scientific inventions and discoveries of the eighteenth century should have been made only by British inventors and scientists. But those who are aware of the fact that the British Isles had been a singularly fortunate country, in that after the Roman invasion it alone was allowed by otherwise turbulent course of history to make peaceful and unhampered economic progress, would easily conclude that under such excellent and ideal conditions British economy should have made sustained and continuous economic advancement. Moreover, the type of resources that the British Isles possessed also enabled its people to take to the industrial road earlier than other people.

One can, therefore, say that it was the cumulative result of a number of factors which enabled British people, at a rather early stage, to take modern industrial production to a high degree of perfection. In the medieval period there were other countries whose technique of production was more advanced than that of England. But while the distrurbed course of history in the medieval period prevented these countries from maintaining the lead they had established, in the modern period, with the discovery of steam as a source of power, England was the first to reach the zenith of industrial advancement.

However, when it was known that machines could be used in the process of production, a class of people came forward, offering their abundant resources to be used as capital for building mills and factories. Most of these people belonged to that class of commercial capitalists who at the end of the feudal period had amassed large fortunes through trade and commerce. Apart from them there were also others who came either from the farm or from the ranks of master craftsmen

and skilled workers, i.e. persons who could manage to scrap together enough money to buy a few machines. This rising class of industrialists, big and small, found the new line of production an extremely lucrative proposition. And, specially after the year 1780, when the steam engine had become quite an effective instrument for driving the factory wheels, it became exceedingly profitable to gather together large groups of workers in big establishments, equipped with steam power.

The outcome of this tremendous revolution in the method of production was sharply reflected in ownership. The power and opportunity to produce was becoming concentrated and centralised in a few hands, while a large majority of people had to work for others for daily, weekly or monthly wage. With concentration of the power to produce in a limited number of people there followed a juxtaposition of classes and clash of economic interests. Now the owners of the factors of production and actual producers, i.e. workers, were two distinct and different classes of people. This cleavage of interests led to a trial of strength between the two groups. In this struggle the owners almost always came on the top, while the workers were often left with their point of view unaccepted by their masters.

Change in Economic Policy

Thus the modern system of industrial production placed more economic power in the hands of the industrialists than of the workers. But the new industrialists were not at all satisfied with this strengthening of their position and agglomeration of opportunities. On the contrary, they wanted more freedom and more power to manage their affairs in ways that suited their convenience most. In other words, they resented the existing laws and regulations which sought to prevent them from employing workers on terms that appeared to be most profitable for their business.

It may be recalled that throughout the sixteenth and seventeenth centuries the dominant industrial policy in England had been the establishment of some authority to regulate conditions of work and employment in the working establishments. To the Parliament of those days it seemed right and natural that the oppressed wage-earners should turn to the legislature to protect them against the cutting down of their earnings by the competing capitalists. But the situation by the middle of the eighteenth century had rather changed. Consequently when the employers began to make strong protests against contemporary wage regulations the House of Commons was compelled to

give up its old policy of protecting the workers and apprentices employed in the trades

The latter half of the eighteenth century was also an age of political ferment On the Continent and specially in France political thought was becoming more and more radical Although England at that time had already a form of parliamentary government yet the rising industrial class was not satisfied with the political control that it enjoyed Industrialists were particularly unhappy with the extensive powers which the functionaries of the State enjoyed in regulating economic life What they wanted was complete freedom of action in running their business enterprises in the manner that appeared to suit their interests best

It would appear strange, indeed that this novel point of view of the vested interests should find support in the writings of the contemporary economists For example, Adam Smith, who is known as the Father of Political Economy, was found advocating, in the course of his writings, a point of view which largely suited the interests of the industrialists And, what is even more strange, that Adam Smith was not the only person who put forth and popularised the new ideology As a matter of fact, almost all the important thinkers of that time—Hume, Bentham, Malthus, Ricardo, Nassau Senior and the rest, who appeared on the stage one after another, put forth a point of view which was more in consonance with the capitalists' view of industrial relations than with that of the workers

Thus the economists of that time started a tradition which is now known as Classical Economics and its exponents are known as classical economists As the classical economists happened to support, directly or indirectly, the contention of the capitalists, they were accused by their later critics of siding with capital rather than with labour Such criticism however, was unfair, for it was based on a misinformed appreciation of the situation What was after all the contribution of the classical economists? It would be readily conceded that their point of view was by no means a new or novel view of industrial relations, it was at the most a generalisation of practical conclusions to which experience of industrial life had driven them along with others From an observation of the difficulties of the industrialists they had realised the requirements of the new age that was dawning And as the governing classes had already been convinced of the gains that would accrue to the community, only if they followed the new economic policy, they readily accepted the new economic theory, more

or less as an intellectual or moral justification of their changed outlook. The result was that what had been done so far purely for reasons of expediency was now to be carried out as a matter of principle.

The Contribution of Classical Economists

Broadly speaking, the classical economists had based their case on the individual's desire to maximise personal, material happiness or welfare by undergoing the least pain. They credited all individuals with such normal, human incentives or impulses, and immediately came to the conclusion that if in a society all individuals pursued such course of action, intended to enhance individual well-being, the result for the whole society would be maximum material happiness or welfare, involving minimum physical or mental pain for the community.

The corner-stone of their logic was provided by the impulse of competition. They envisaged a state of affairs in which each individual would freely compete with another to further his economic ends. And, to be fair to them, it must be stated that such a right and freedom of competition they contemplated not for any one section of the people only. Rather they imagined a state of affairs in which capitalists would compete with brother capitalists, workers would compete with fellow workers, capitalists as a clsass would compete with the workers, peasants would compete among themselves and with the landlords, businessmen would compete among themselves and with the consumers, and so on, to secure for themselves the largest share from the national income. It had been assumed by the classical economists that by doing so people would be automatically increasing total national wealth and human happiness.

In order to make the field of such competition free and unlimited, they advocated *laissez faire*, which meant non-interference by the State in the day to day economic life of the people. The basic idea inherent in the concept of *laissez faire* had been taken originally from the French thinkers, but its practical application mainly in the domain of economic life was the contribution of the classical economists. Their contention was that if the governmental machinery interfered with the economic decisions and preferences of the people individuals would not be able to produce the quantity and quality of goods that they desired, and in such a case material welfare would not be of the maximum order. Therefore, after assigning such elementary duties and tasks to the State as defence and maintenance of law and order in the kingdom, they proceeded to prescribe a course of policy for it which made it

obligatory on the servants of the State not to interfere in the economic life of the people. In other words, they disapproved of all governmental action which under any circumstances was likely to restrict the judgement and decision of the individual to produce or consume what he desired.

Now, it must be admitted that the classical economists had propounded their theories in good faith, and it is also an undoubted fact that if economic forces, trends and events had been allowed to operate in the manner suggested or imagined by them the world perhaps would not have become such a sorry place as it actually turned out to be. The blame for subsequent events therefore, by no chance can be laid at the door of the classical economists. Their fault, if any, could only be said to consist in a defective or incomplete study and understanding of human nature. This will become more clear as we proceed with an examination of the practical working of the capitalist economy.

How Capitalism Works

It had been assumed, for instance, by the classical economists that when a person decides to invest money in production he inevitably gives employment to a number of men and an amount of materials, the wholesome effects of which on the total economy of a country become immediately visible. In other words, production of goods by an individual producer means simultaneous production by him of certain amount of purchasing power for the sellers of land and raw materials, for the sellers of power and machines, for the sellers of human labour and for the sellers of technical skill managerial organisation and efficiency. Thus the decision of one person to produce goods with the help of a factory or a mill automatically causes an increase in the income of a considerable section of the community. And as the number of such producers increases the income of the community also increases. But the number of producers would increase only when production proved profitable. Therefore, one can for this reason say that under capitalism profit is the *sine qua non* of production. But from this none need conclude that in capitalistic production losses do not occur. Such a view apparently would be born of ignorance of the actual conditions in which modern industrial production takes place. The emphasis on the profit factor is placed only for the reason that the consideration for it alone persuades one to produce. What therefore, is to be underlined is that the motive behind capitalistic producton is not of an altruistic nature, i.e. people do not produce with a view

to do good to the society. Such an opinion could hardly be entertained specially when people were seen producing even those goods which were only likely to do harm to others, e.g. poison gas or the atom bomb. But one should know that as long as even injurious production can bring good returns to the producer in terms of economic gains, it would be produced. It is for this reason that one can say that what the producer is mainly and primarily interested in is profit. In fact, this is such an important consideration that even a useful commodity like bread would not be produced in a large quantity if its production is not found to be a profitable proposition. धारणा

In the feudal period, on the other hand, people produced these items of personal consumption primarily with the view to meet personal requirements, irrespective of the fact whether in terms of money it was a profitable activity or not. But under capitalism one does not always produce things required for personal consumption. On the contrary, we find persons, who are well provided for, producing such commodities as are not at all required to meet their individual or families' needs, e.g. production of iron and steel by Tatas in millions of tons. Obviously these commodities are produced in such large quantities only out of consideration for profits. This in our judgment is the main difference between production in the capitalist period and production in any other period of human history.*

Characteristics of the Capitalist System of Production

The other important characteristic of the capitalist system of production is that, land having ceased to be the most productive source of income, henceforth capital goods, i.e. machinery, factories, mines, mills, banks, railroads, shipping lines, etc., become the chief instruments of production.

* This point is rather controversial in nature. One can, for instance, object to this analysis on the ground that profit motive under capitalism also finally seeks to provide one with the means to satisfy personal wants. In some cases it is, no doubt, true; in fact in small-scale production this is largely true. But one must remember that when we talk of capitalism we do not generally think of small-scale business enterprise. On the contrary, at such a time the centre of our attention is large-scale, mechanised production made possible by gigantic industrial units, intended to produce fabulous returns. Thus our conclusion in substance is valid. A part of profits thus earned can well be spent on personal needs and requirements. But profits under capitalism, in the main, are earned, in the long run, to earn more profits and more profits, which are finally utilised to exercise power over society and to enjoy the knowledge of having that power.

The capitalists who own such property wield vast economic power, which they use for enhancing private profit Each entrepreneur who sees an opportunity of earning profit borrows capital, establishes an industrial unit, employs engineers to build, administrators to organise, workers to toil, and hopes to find a market in which he can sell his product for more than what it cost him to produce Thus, an elaborate mechanism of production, distribution and exchange is set up, with supply and demand determining prices, prices determining profits, and profits determining the allocation of land, labour, and capital among various enterprises

The regulator of the capitalist world is price ' Movements of price determine and condition the working of the capitalist system The function of the price mechanism is to condition both demand and supply Price movements ration restricted supplies The whole system works with certian amount of simplicity, e g rising prices discourage consumption and falling prices encourage it At the same time it works with such efficiency that it always restrains demand from outrunning supply in the long period, it functions equally efficiently in the other direction too

The other function of the price mechanism is to decide what would be produced how much would be produced and at what point production of that commodity would come to an end If people want a particular commodity and they are prepared to pay its price, resources would be diverted to this line of production Like this the price system helps in the allocation of resources It determines both the choice and avenue of production

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Every system of production has to rely on some method of forecasting Under capitalist production it is price mechanism which does all the necessary forecasting for it As one knows, the price mechanism functions mainly through the agency of the market The market is the sole economic regulator According to market price fluctuations men are employed or dismissed, factories built or dismantled, wealth produced or destroyed, progress made or retarded It is claimed that the price mechanism distributes the factors of production in each industry upto the point where the marginal net production is equal to the average rate of remuneration and the marginal cost is equal to price The result is optimum employment and output on the one hand, and maximum aggregate satisfaction, on the other

Since sugar production proved a paying proposition the number of such producers would increase (the spirit of competition helping and accelerating the process) till a stage was reached when on account of continuous fall in the price of sugar, the margin of profit would become either very small or nil It would happen like this As more and more producers enter into competition with one another in producing larger and larger quantities of sugar the total supply of sugar would increase and with every increase in supply, according to the laws of supply and demand its price would constantly fall It should be apparent that only when the price of sugar goes on systematically falling that larger and larger sections of consumers would be able to purchase it Thus, when in a spirit of competition each producer tries to produce as large a quantity of sugar as he can with increase in total output he must agree to reduce his price, if he wants that his produce should sell in the market in preference to others But when one producer reduces his price other producers must necessarily reduce their respective prices for according to the definition of a perfect market there cannot pervail two prices in the same market, at the same time, and of the same commodity

Falling Prices and Declining Profits

Thus it would be seen that the spirit of competition, apart from producing other results, progressively reduces the margin of profit for the producers Producers finding themselves in such a helpless position, naturally try to avert this reduction in profit and, in order to succeed in this, they take resort to every measure which can help them to keep the margin of profit at least constant, if it cannot actually be increased

The best method of averting such a precipitate fall in profit obviously would be to increase the price of the commodity, or at least prevent it from falling But under competition this is not possible, for when price is determined by the laws of supply and demand an individual producer cannot control the price of a commodity So the next course open to him would be reduction in the cost of production. This every producer can do in some measure or other But here, again, difficulty arises due to the desire of the competing producers to produce larger and larger outputs Naturally, when producers are competing among themselves to produce increasing quantities they would be compelled by the sellers of labour, raw materials, power resources and other items required in production to make increasing payments to them if the latter are to be persuaded to sell their things to the former

One can now understand why classical economists had believed that competition would not only benefit the capitalist but it would also benefit other classes of people, who would be taking part in production or happen to be related to it. It was, in fact, mainly for this reason that they had imagined that with increasing production and employment workers would receive more and more wages. And it was this optimistic approach to production and society which had led them to believe that the impulse of competition would compel the producers to distribute larger shares to other agents of production, which alone would encourage the latter to supply their commodities in increasing quantities. All this would result in increased income for the community which only would insure the sale of the goods currently produced.

In this manner, one line of industry would be fully developed, leaving finally little or no margin of profit for other inverstors to enter this line. Then the same story would be repeated in another line of production, till that one was also fully developed, producing almost identical results for producers, workers, sellers of raw materials and other members of the community associated with production. After this, still another line of poduction would be opened, where also, in the long run, the impulse of competition would produce the same results. This process, in fact, would continue until the total economy of a country was fully developed, bringing all round prosperity, well-being and happiness to mankind. The sum total result for the community would be maximum social welfare—'the greatest good of the greatest number', the ideal promised by the political thinkers.

When the dazzling prospect of such an excellent future was held out before humanity, who would have refused to heed the words of the classical economists? Who would have not agreed to give them at least a chance of substantiating their promise? It is also true that in the beginning the broad outline of things was turning out to be exactly as had been predicted. Capitalist enterprise, in its initial stages, was associated with certain amount of dislocation and misery too. But it was readily diagnosed to be an evil associated with every major change in the form and method of production. Nearly all seemed to agree that in a period of such change certain amount of misery and suffering was inevitable, and that in the long run man would gain from such an involuntary sacrifice. So the protests of the dissatisfied and the disgruntled were silenced and those who tried to be unduly eloquent in their indictment of the new age were disregarded.

CHAPTER LIII

CRISIS IN CAPITALISM

How Things Went Wrong

Although the prophecies of the classical economists turned out to be largely true yet they did not prove completely correct. Trouble first arose on the side of the workers. It had been hoped, one may recall, that with increased production workers' share in national income would increase which would inevitably bring about all round improvement in their economic and social conditions. As a matter of fact while advocating the repeal of governmental regulations which sought to interfere with workers' employment and fixation of wages classical economists had assured automatic improvement in these spheres only if the new economic forces were allowed free play. For they had hoped that when producers compete among themselves to employ increasing number of workers they would be compelled to meet the demands of the latter, which would inevitably cause reduction in the hours' work per day and increase in daily wages.

But in actual experience it was found that the condition of the workers was worsening almost in every respect. In fact, at times and on places they were required to work fifteen to sixteen hours per day and were made to live in the most unhygienic and insanitary conditions. Their wages were too small to guarantee even reasonable livelihood. There was deterioration in other respects too, and gradually their problem was assuming alarming proportions. This naturally makes it necessary for us to examine and see why and how one of the major assumptions of the classical economists broke down so completely in practice.

Advance in production on capitalistic lines was associated with two social trends which had not been clearly foreseen. Firstly, it was discovered that when the pace of industrialisation quickened increasing number of people were migrating from the rural areas to the urban centres. Secondly, industrial development of a country was invariably accompanied with increase in its population. The result of this two-fold development was that the supply of labour was generally more than the demand for it. This irresistibly led to a general depression in the labour

market. As the industrialists were primarily interested in maximising their return on capital, they tried to take full advantage of this situation. Consequently workers found themselves in a very unenviable position. Not only were they not paid what could be called a living wage, but they were also made to work excessively long hours in the most unsatisfactory conditions. Thus opened a phase of most remorseless exploitation of the working classes, who finding the current of the time against them took resort to one preventive measure after another.

But, as ill-luck would have it, each such device adopted by the workers only further worsened their condition. For example, when they found that their daily earnings were insufficient for maintaining their families, they sent their women folk also to work in the factories. Obviously the line of approach was that, apart from what the male members of the family earned, if the women also worked and earned something they would bring additional income to the family. Now, when the logic of the workers themselves was such, there could hardly be anything surprising if female workers were actually offered lesser wages in the labour market than men would have been prepared to work on. This development in the labour market only strengthened the hands of the industrialists. With increase in the supply of labour and with the presence in the labour market of a class of workers who were willing to work of their own accord on lesser wages than men could agree to, the general wage level further went down. Thus, the female workers, who had gone to work in the factories to augment the family's daily earnings, only succeeded in reducing the wages of the male workers.

When this device failed to produce the desired result the other thing that the workers possibly could do was to send their children also to work in the mills and factories. But with the coming of the children in the labour market the situation for the workers further deteriorated. As these children could not expect to get as much wages as the adults were being paid, they agreed to work on a wage which was even lower than what the female workers were getting. The producer always calculated in terms of costs. It was obvious to him that a woman could never work as hard and as long as a male worker could, and it was clearer still that a child could work even less than his mother could. Thus wage rates sloped down gradually from adults to juveniles.

All this only helped to aggravate the nature and magnitude of the social malady. The capitalist, being primarily interested

in keeping down the costs, forced women and children to work as hard and as long as he could make them work. Thus misery multiplied, health declined, the resistance of the body to illness and mortality diminished, which all culminated in high death rates While all these man-made problems were there, God also made his token contribution—while death-rate was rising birth-rate also in this class of people showed sings of alarming increase. At that time one could hardly say whether it was the law of natural compensation working or it was the answer of Providence to the greed and cupidity of man. From a study of the prevailing situation the sombre conslusions at which Malthus arrived are known to all. We may not agree with those conclusions is another matter.

Workers Organise

We have said before that the latter half of the eighteenth century, politically speaking, was a revolutionary age. With the coming of the nineteenth century, however, the political approach to the problems of life and society was not by any chance given up; in fact it became only more intensified So when the British workers found themselves in such a sorry state they set about the task of organising themselves on a class basis. Thus the idea of forming trade unions was born and, soon after, throughout the industrial parts of Great Britain trade unions were formed in quick succession and in the midst of great enthusiasm The main object of these trade unions was to bring about an improvement in the working and living conditions of the workers through organised, collective action. They repeatedly appealed to the State authority to intervene and redress their grievences. But the Government of that time found it difficult to reverse the policy which it had revised only a few decades earlier. Consequently, when the trade union leaders found the State apathetic towards the workers' demands, they called upon the workers to go on strike with a view to compel their masters to accept their demands. Sometimes these strikes were successful and on other occasions they failed miserably. But in course of time and with accumulating experience these trade union organisations became stronger and their combined pressure on the industrialists increased, in spite of the sympathy and weight of the Government being, for all practical purposes, more on the side of the industrialists than of the labourer. Employers did all that they could to curb the turbulent spirit of the workers and proceeded to break their organisation and smash their militant strike actions. But against all difficulties the trade union organisation continued to make headway.

This unrest and strife, however, could not be allowed to continue for long. Slowly and gradually Great Britain was drifting more and more towards democratic forms of Government. Parliamentary democracy necessarily meant respect for the point of view of the common man. So British Parliaments gradually proceeded to redress the grievances of the industrial masses. Each legislative measure passed to protect their interests, however, encouraged the working classes to press for greater safeguarding of their interests. In this way Acts after Acts were passed by the House of Commons to compel the industrialists to meet the point of view of the workers. Industrialists generally opposed such legislation. Their argument was that each concession they had to grant to workers on the behest of the State meant further increase in the costs of production. Consequently they spared no efforts to oppose the Government's desire to protect the workers and to resist the demands of the workers generally. But the swing of time was now in favour of the underdog and , therefore, the employers' efforts to the contrary proved of little avail. At the most they could succeed only in slowing the pace of labour legislation.

The Deadlock

What was capital's answer to this challenge ? The answer, in fact, was provided by the peculiar nature of the capitalist production itself. With every advance in industrial production more, better and cheaper machines were being produced. Increasing use of these machines, apart from producing more and cheaper goods, also reduced the number of workers employed in industrial establishments. Therefore, particularly for this reason, industrialists found it, in the long run, more economical to have these highly expensive machines rather than to employ large number of workers, whose daily increasing wage demands were regarded an intolerable burden on industries. In other words, as these machines proved to be labour saving devices they could be conveninetly used as an effective weapon to break the resistance of the workers' trade unions.

The second prong of the capitalist attack was provided by the factor of monopoly. Industrialists from their long experience had learnt that unlimited competition only undermined their own relative position, individually as well as collectively. The more the producers competed among themselves the more they weakened their own position. Therefore, capitalists as a class came to realise that it would be infinitely better to combine

Combination among producers along monopolistic lines helps them to command large financial resources With such vastly increased capital resources expensive labour saving machines are ordered for Thus, when the demand for capital goods increases there comes to prevail great prosperity in the capital goods producing industries And when the margin of profit is found to be larger in the capital goods producing industries larger investments are attracted towards them, resulting sometimes in their disproportionate expansion and unbalanced development Ordinarily there should be nothing wrong in such a tendency, for the growth of this class of industries should in the long run, only help to give more employment to men and materials in a country

But there are some peculiar characteristics of the industries producing capital goods which cause all the complications. Production in these industries happens to be rather 'round about' in character As the production of machines takes long time, conditions obtaining in such industries cannot be directly related to the demand for them, neither this 'indirect' production is related to the actual conditions obtaining in the business world In marked contrast to this, conditions in the industries producing consumer goods are directly related to the demand from the public for such goods The relation being of a direct nature expansion in them can only take place when there is increased demand for the goods produced by them Similarly, when there is contraction in the demand for such goods, one can easily imagine contraction in the production of such goods On the other hand in the capital goods industries, as the demand for capital goods is a derived-demand from the demand for consumer goods, production of capital goods cannot be immediately or directly related to the demand for consumer goods In other words, production of capital goods is not directly related to the market conditions obtaining in the business world

To illustrate our argument let us take a practical example. Suppose the demand for consumer goods is showing signs of increase As a result of such increase production of consumer goods would be increased And when these industries begin to produce larger bulks of goods and these goods are sold with a profitable margin, the owners of such industries would be inclined to order more machines to be used in the running of such industries Proprietors of capital goods, seeing larger demand for their output, would either start producing more capital goods or, if the demand is very great, they would set about planning expansion of their industries by starting new ones in order to produce more

capital goods in the years to come. But all this naturally takes time, and consequently sometimes it so happens that by the time large number of machines and plants are produced the demand for the same from the consumer goods industries is reduced. Such a situation in the real world is not only possible but, in certain circumstances, altogether inevitable.

For example, there is at present great demand for capital goods, plants, machines, etc. all over the world. U. S. A. happens to be the only fortunate country which can largely meet such world demand. Therefore, in order to meet this increased demand for machines and plants, American producers, for instance, at present are doing two things. They are either trying to produce as many machines as their present producing capacity can allow them to produce or are planning the setting up of fresh capital goods industries with a view to produce more machines and plants in the years to come. Both these processes, however, will take time. So it is quite possible that U. S. A. may not be in a position to meet the total world demand for machines before the year 1956.

Now, the danger is that when American producers have invested billions and billions of dollars in the production of these goods and in the expansion of such industries it is revealed that, on account of the demand for consumer goods having in the mean time declined for various reasons, industrialists all over the world are not in a mood to order as many machines as they had hoped to buy originally. When this comes to be known great nervousness and consequent panic would prevail in the capital goods industries. At such a time prices of their shares and securities would decline. But this would only further intensify the panic. Holders of such shares and securities would start disposing them of in a hurry and excitement. Thus capital would be withdrawn from these industries, leading to the closing down of many of them. It may be noted that it is this peculiar feature of the capital goods industries which is responsible for most of the world's misfortunes in modern times.

When such a situation develops usually it takes long time to effect corrections in these industries. In the meanwhile stagnation sets in. Slump conditions come to prevail causing reduction in the employment of plant, men and materials, which depress both wages and prices. At a time like this the Stock Exchange loses confidence and credits are called in. The financial crisis starting from the Stock Exchange spreads to the industries producing means of production in an intensified form. The collapse or closing down of

the capital goods industries causes further unemployment in the labour market which, through lowered demand, spreads in an aggravated form to the consumer goods industries This causes unemlployment on an increasingly wider scale In the mean time full scale slump sets in when every department of production is affected adversely, leading to full fledged economic depression

Let us now analyse booms and slumps in their proper sequence In a phase of recovery producers generally are optimistic Seeing the prospect of high profits they are inclined to expand their individual scales of production More production means more employment of men, materials and machines More employment of these factors leads to greater disbursement of purchasing power to the community With greater purchasing power in their hands consumers go to the market to purchase all kinds of consumer goods Thus, when the demand for consumer goods is high prices rise And when prices rise profits also rise So in the expectation of continued rise in prices and in anticipation of high rates of profits producers expand their scales of production still further But production can increase further only when producers are prepared to pay higher remuneration to workers, technicians managers, organisers, to suppliers of raw materials, machines and power as well as to the suppliers of credit, i e bankers For the time being as the producers are generally in an optimistic frame of mind, they do not mind increased payments to the various agents of production and, in fact, they pay whatever is demanded of them Thus we find that more production takes place only at a higher cost of production

When costs of production increase they must be invariably reflected in rising prices Rising prices usually insure larger profit margin Therefore, in expectation of profit, production increases still further But now agents supplying factors of production would demand still higher remuneration and prices for their services and goods needed in production This situation however cannot be allowed to prevail indefinitely In view of costs of production increasing rapidly producers would be less inclined to pay higher prices for the goods and services which they consume in the productive process As the wage-bill generally happens to be the largest single item in the costs of production in most industries at this stage an acute trial of strength would start between capitalists and workers Partly the demands of the workers would be met but partly they would be by passed by the capitalists by ordering more expensive machines

which, in effect, reduce the wage bill that producers otherwise would have paid to workers. But, in spite of all efforts to the contrary, costs of production go on rising, prices following the lead given by rising costs. Thus, on account of rising prices, the workers' cost of living also goes on rising. In order to cover this increased cost of living they become even more insistent for increased wages. But at this stage all the efforts and energies of the capitalists are directed to 'rationalising' and decreasing costs of production, mainly by reducing man power and its share in production.

While all this is happening capital goods producing industries are making good profits. Consequently more and more people invest their capital in such industries. At such a time prices of the shares and securities of the capital goods industries rise unduly. Capital goods industries thus go on expanding without showing much appreciation of the conditions obtaining in the real world. But, as we have seen, working classes generally, on account of increasing use of machines in production and monopolistic tendencies on the part of the producers, do not in times like these get as much wages as they should. In fact, money wages are not only not equal to the increased cost of living but they actually lag behind the marginal productivity of labour. In other words, workers do not get the equivalent of the value that they produce. The result is that while production is still increasing at a tremendous pace the consuming capacity of the community ceases to increase in the same proportion or at the same rate.

The other significant tendency on the part of the producer at such a time is to produce as much as is physically possible for him. One of the major defects of the capitalist system is that production under it takes place without producers knowing exactly the possible volume of demand for such things from the consumers. The other defect is that each producer seeks to increase his volume of production without disclosing to other producers his scale of expanded production. So every producer is , for all practical purposes, in the dark about the increase in the scale of production of the other producer. Thus, while sometimes the total quantity thus produced is less than the total demand for it, at other times it is just equal to it or even more than the total demand. When the last situation arises it is a case of over-production in relation to current demand.

Economic Depression

Trouble at such a time usually starts like this As costs of production rise prices also rise With rising prices, goods currently produced are not sold Thus, from year to year producers and wholesalers carry forward accumulated stocks of goods With the accumulation of unsold goods prices show downward trend But when the danger of falling prices faces the producers they generally become cautious Banks at this time are inclined to put stringent conditions on advancing credit Rates of interest soar high At this stage conditions become practically stationary in the business world—there is neither expansion nor contraction for the time being But under capitalism a stationary situation, for all practical purposes, is as dangerous as a declining one Usually capitalist economy is either expanding or contracting, it seldom remains stationary In fact a stationary condition is often the harbinger of evil Such is the dynamics of the capitalist system of production It cannot be easily explained with the help of logic or reason But this is what usually happens As each system of production has its own laws of movement, capitalism reveals this peculiar dynamics

However, as soon as the stationary position is reached there is complete stagnation in the sphere of production As we have mentioned before, at a time like this trouble starts mainly from the capital goods industries, which being unduly developed are always affected first There is a sharp fall in the prices of their shares and securities Adverse developments in this class of industries lead to a reduction in the aggregate income of the community With diminution in total income there would naturally be a fall in the demand for consumer goods And when there is such a fall in demand, prices go down generally, causing decline also in the consumer goods industries When consumer goods industries are hard hit they cancel orders for capital goods, which causes further decline in the industries producing capital goods Investors in a state of panic begin to withdraw their capital from these industries Now the car of capitalism is in the reverse gear Disastrous developments take place in quick succession and almost at a sensational pace The effort and enterprise of years is ruined in no time Unemployment becomes universal experience, which causes poverty and pestilence Industries are closed down Raw materials and power resources remain unsold Thus there is an all-round depression, affecting not only one country but, one after another, all the countries of the world

As in the modern period of history different parts of the world are inter-linked and inter-dependent in one sense or another, if there is prosperity in one part of the world it invariabley spreads to other parts. If, on the other hand, there is depression in one part, it irresistibly spreads to other parts. Such is the nature of the economy of the present-day world.

With the onset of the depression, along with its financial and other repercussions affecting the national and international economy at large and with widespread economic misery and social distress, the critical juncture is reached. From this nadir the decline again leads to improvement and now dynamic movement is in right gear. The same process is repeated, which again culminates in a crisis' Thus, it would be seen that between one crisis and another industry passes through a certain circle or, as it is called, cycle. It is for this reason that the whole phenomenon is known as trade cycle. As an illustration it would be worth noting that in the period before the First World War the following was the pattern of crisis, depression and recovery. Crisis in the financial or the capital market usually gave place to depression, then this depression passed over into moderate revival. The revival in turn gave place to a period of prosperity, when expansion and race for profits reached their highest points. Then a crisis came and the cycle was begun anew. Thus it would appear that the capitalist system is associated with a sort of tidal movement—increasing prosperity rising to a boom, then bursting and falling into a slump occasioned by a financial crisis, after which recovery gradually sets in again.

Symptoms of Permanent Depression

It has been noticed of late that with advance in industrial production economic depressions are becoming more and more severe in their impact. The result is that usually it takes a long time to clear the debris of devastation and misery caused by a depression. Moreover, as the nature of the world economy is becoming more and more industrial economic depressions show pronounced tendency of affecting larger and larger regions of the world. Furthermore, the more industrially advanced a country is the more hard hit it is by the violent impact of a depression. Consequently, in the present century the economy of the United States was always affected first, and also most, by the violence of a depression. But, what is even more alarming, of late a sort of permanent depression is becoming inseparably associated with the capitalist economy. While in the old days unemployment increased and available resources

could not be fully utilised only in a state of depression, it is now being noticed that even when the boom is touching the peak point there is considerable unemployment of men and materials In other words, depression is becoming endemic in the capitalist system This is surely a disturbing sign from which some authorities have drawn the conclusion that capitalism in its advanced stages would show increasing signs of failure to utilise currently available resources in production

It was from such a belief that an economist of the eminenec of Lord Keynes arrived at the conclusion that as capitalist production advances on its course net investment on private account would show increasing tendency of lagging behind that ideal quantity of investment which would be needed to bring about conditions of full employment of men and materials in a society This ideal investment is also known as optimum investment Apparently this view does not seem as serious as it really should The conclusion which would be drawn from such premises is that the gap between real and optimum investment being an ever widening one it should be progressively filled by investment on State account, i e by spending increasing amounts on such projects as public works, development of social service etc

This is exactly what Keynes advocated in the course of his writings He emphasised that State expenditure from year to year should expand in order to fill the gap between actual and optimum investment and thus help to maintain full employment of men and resources in a country For, according to contemporary economists, the highest economic ideal at which a modern progressive Government should aim at is the maintenance of full employment in a country One can imagine what a serious departure is this from the original stand of the classical economists, who had advocated non intervention by the State in the economic life of the people

This is however only one of the remedies suggested as the cure of the crisis in capitalism As we are not discussing remedies and solutions of the problem here, we may proceed after emphasising that even when boom conditions are obtaining the situation by no means is satisfactory For instance, among other things that happen in a boom, the tendency on the part of the producers (in order to avert the fall in prices and profits in view of increasing supply of consumer goods without there being corresponding increase in demand for

them) to change the nature of production is most serious. When producers are faced with the awkward possibility of falling prices they try to divert their investments more and more towards the development of 'secondary' and 'tertiary' industries, which are devoted to the production of all kinds of luxury goods, armaments, harmful commodities and drugs, like opium, cocaine, heroin, etc. As there is great inequality of income in the society, even such superfluous, useless and harmful commodities are produced and fetch good prices, when the majority of the people do not have even two square meals. Thus, for the time being the problem of capitalism is solved, and the precipitate fall in prices is prevented. But, as we have seen, this problem is solved only for a short while, for the evil day cannot be postponed for long, much less for ever. Ultimately when it is discovered that even such goods have been produced in larger quantity than can be sold at reasonable prices, conditions of slump come to prevail. But, apart from slump and crisis and depression, the question is how far economically, ethically or morally the production of such superfluous or harmful goods can be approved or justified when the majority of people in the world remain hungry or underfed, apart from going without other necessaries of life.

The Need for Change

There are several theories propounded by professional economists and others which seek to explain the various phases of capitalist production. It would be hardly appropriate to examine them here, for they form part of economic theory which is meant for the study of advanced students of the subject. For our pruposes this simplified and elementary description of the phenomenon of the trade cycle wolud suffice for understanding and realising the necessity of changing the system for something better. It must have appeared to our readers a strange and serious matter indeed that such cataclysmic changes should take place in our system now and then without rhyme or reason. What is still worse, crises and depressions sharpen class contradictions and aggravate the unenviable condition of the workers by increasing unemployment at a tremendous rate. Such a situation compels the working classes, who formerly tended to be at peace with captalism, to become active in the struggle against it. We can support this by our experience during the economic depression of 1929-32. For example, within two years of the depression Germany was on the verge of revolution, many States abandoned democracy for dictatorship, five South American republics suffered revolution, a

war was brewing in the Far East Finally, Italy and Germany took to national militarism From this one can conclude what a dangerous thing is economic depression in the life of a nation. The colossal price which it demands in terms of suffering, extreme poverty, wide-spread pestilence and unbearable trial of the human soul is simply incalculable That it also becomes *the strongest single argument in favour of world wars* is another aspect of the matter which we will be discussing in the following chapter

CHAPTER LV

SOCIALISM

Promises Not Fulfilled

The advocates and exponents of the capitalist system had held out the promise of a form of industrial production that would create a millennium in which by practising the principles of competitive, private enterprise not only the people of one country would become happy and prosperous but the whole world would be enabled to participate in that feast of well-being and progress, more or less on an equal basis. They had also predicted universal harmony and peace in the salubrious climate of which each part of the world would develop economically, without giving cause to friction or conflict between the interests of one country and another. But what was world's acutal experience?

Even in the industrially advanced countries prosperity and happiness had not become a common experience, nor was plenty shared equally by all wherever it existed. In fact, while one class of people had become rich out of all proportion, the vast multitude was left to live the life of want, poverty, misery and privation. The economic development of the world, instead of following any easy or smooth course, had come to a standstill in many parts due to the attitude of the adventurous and ambitious nations, which sought to perpetuate the economic backwardness of the less developed countries in order to be able to sell to them their own manufactured goods.

Further, it had been assumed that the principle of *Laissez faire* would be equally applicable in the sphere of international trade, and if the latter was allowed to take its own course, unregulated and unrestricted by any external authority, it would confer benefits on undeveloped countries as much as on the developed ones. But in reality, specially after the emergence of such ambitious competitors as Germany, U. S. A. and Japan, international trade ceased to be conducted on the principles of free trade. In fact, foreign trade came to be increasingly backed, boosted and bolstered up with duties, tariffs and quotas, adopted by the Governments of the countries which

were in a hurry to take lead in the competitive race of international economy.

Thus, combined world economic development on any fair and equal basis became an impossibility. The industrially advanced nations had managed to gain political foothold in the backward parts of the world, where they tried to establish exclusive rights of selling manufactured goods as well as of investing surplus finance capital by deliberately thwarting and crippling the economies of such areas.

Similar privileges were claimed by other countries which entered the fray a little later. This led to a trial of strength between the industrially advanced nations, on the one hand, and between these and the backward areas of the world, on the other, on the issue of colonial exploitation. These developments made the dreams of world peace and progress impossible. As a matter of fact with the march of time friction and conflict between the rival capitalist nations only increased further which compelled them to adopt openly imperialistic roles in world politics.

When matters had become so complicated and the dream of universal well-being, prosperity and peace had disappeared in the thin air, attempts by the students of the subject began to be made to analyse the nature of the malady with a view to restoring reason and sanity in the economic affairs of the world. Explanations followed explanations in quick succession. But none could suggest such a remedy as could prevent the recurrence of the evil or even explain the nature of the trouble. Consequently, we are left here only with some divergent theories. No useful purpose, however, would be served by going into analytical or historical details of such theories. On the contrary, a dispassionate study of the problem, along with its suggested remedies, would perhaps be more helpful.

The Birth of the Socialist Idea

असमानता

The apparent shortcomings and glaring inequities of the industrial system encouraged its critics generally to become louder and more vigorous in their criticism and condemnation of the economic and social results of capitalism. Capitalism had its critics from the earliest phase of its rise and growth—in fact even before capitalism had come into vogue there had existed strands of socialist and communist thoughts. But as long as capitalistic enterprise was able to dazzle the imagination of mankind by its promise of

freedom, equality, justice, rationality and 'the greatest happiness of the greatest number,' its critics could hardly feel sure of their own criticism or create much impression on others.

But since capitalism had now produced its own nemesis, in the form of booms and slumps, crisis and depression, unemployment and poverty, international friction and war, the voice of its critics became more strident and their logic more convincing. They offered all manner of explanations and suggested a variety of remedies. While some adopted a constructive approach, basing their case on reform and education, others seemed to run amuck under the intoxication of their own irrational approach. For example, first came those romantic reactionaries who advocated the breaking of machines as a remedy of all the ills which had been created by capitalism, and pleaded for a return to the past. But, naturally, such insanity could not prevail for long, much less succeed in its purpose. Then came those who began to dream of a heaven which could be created on this earth only if men decided to co-operate, instead of competing among themselves. Robert Owen, the chief exponent of this idea, went to the extent of establishing one such ideal society, where by the elimination of disorderly competition and faulty education mankind was intended to be won back to the path of progress and peace, through a reassertion of the religious, moral, cultural and ethical values. But to the practical and realistic imagination of the people of that time this innocent panacea did not appear to solve the colossal problem that was capitalism with all its evil manifestations.

Others advocated still different views and policies. But almost all of them happened to lay emphasis on the organisation of workers on trade union lines, which was supposed to compel the employers to yield all that their employees wanted. As a result of this emphasis trade unions were formed in Great Britain as well as in the European countries. But the organisation of workers on trade union lines only further intensified the struggle between labour and capital instead of resolving it. In answer to workers' organisation, industrialists combined to beat the former at their own game. So the conflict and ensuing struggle between the two assumed serious and alarming proportions. At this stage another view seemed to gain popularity,—one which attributed all economic and social ills to the idea and institution of private property. Proudhon, the French thinker, shouted :

'Property is theft, property owners are thieves.' His argument was that if somehow property could be abolished everything would be well with the economic world

But still the critics of the capitalist system were as much in doubt about the real nature of the capitalist evil as its advocates and exponents were mystified and bewildered by its intractable ways In view of this everybody seemed to be groping in the dark, without finding the end of the blind alley The idealists and the Utopians failed in suggesting a way out of the great impasse, while revolutionaries realised the futility of their radical doctrines

All those who criticised and condemned the capitalist system are broadly known as socialists and all their theories are put under one head' Socialism They all sought to reform, reject or replace capitalism by suggesting schemes of radical social reform and equitable distribution But nearly all of them failed to suggest anything of a practical nature, which could achieve the desired end And even those who did succeed in suggesting an alternative failed to mention or devise the agency which could abolish capitalism and replace it by a more humane system Being idealistic in their approach, the schemes they suggested turned out to be unpractical Utopias All of them thundered against the criminality of a system which enabled a class of idle rich to prosper by exploiting the honest labour of others, but none succeeded in giving the outlines of a system which could take its place It was only Karl Marx s comprehensive and synthetic genius which ultimately gave a more or less scientific explanation of the defects and wrongs of the industrial phenomena and also indicated the agency through the efforts and initiative of which capitalism could be overthrown and Socialism enthroned in its place Believers in such a point of view are also known as socialists

The Socialist Thesis

There are, however, socialists and socialists, and it is next to impossible to define a socialist Apart from socialists as such there are Anarchists Syndicalists, Fabians, Guild Socialists, State Socialists, Communists and others, all of whom take their stand on varying programmes which, scientifically speaking, can scarcely be separated from the fundamental principles of Socialism as they are understood today Then there are also many derived academic theories

which, while mainly emphasising the economic approach and explanation, take inspiration from and come very near the socialist doctrine.* In view of these varied, divergent and in certain respects conflicting view points it would be difficult to define Socialism in a manner as to make it acceptable to all these schools of thought. For example, George Bernard Shaw defines Socialism as "the complete discarding of the institution of private property......... and the division of the resultant public income equally and indiscriminately among the entire population," a description which would not apply to the social order advocated by many socialists. Hence, instead of attempting a generally acceptable definition of Socialism, it would be better for our purposes if we elucidated its basic principles, defined its objectives, and indicated the means of achieving it.

Socialists seek to explain all the evils associated with modern industrial society in terms of the innate and inherent defects of the capitalist system of production. For instance, they trace the source of all trouble in the industrialists' competitive greed for profit and draw the conclusion that so long as production was based on such a narrow and irrational consideration universal plenty and general well-being could never be achieved. They argue that as after a stage it pays a capitalist more to produce less (for rising production causes a fall both in prices and profits), the greed for profit would always serve as a brake on production. So, in their view, in order to ensure plenty and prosperity for all it is necessary for the profit motive to cease to be the main criterion and motive of production.

But when profit is abolished no industrialist would like to produce, for under capitalism goods are not produced for altruistic reasons. Accordingly, socailsts say that, instead of private individuals being allowed to remain the owners and controllers of production, all factors and means of production should be owned by the State, which should produce goods not for profit

* Even apart from these points of view which are socialistic in origin and inspiration, there are some political cults which claim to be socialist in form and content yet are not socialist in substance and reality. National Socialism of Hitler's Germany would serve as a good illustration. National Socialism no doubt included in its programme some such features as closely resembled 'Socialism,' but it would be a mistake to consider Nazism under Socialism, for, if anything, National Socialism was a reaction against Socialism.

but for consumption by the community.* In other words, when State comes to produce goods, naturally, that quantity would be produced which is needed by the people at large, irrespective of the fact whether it yielded profit or loss And if in a particular line of production loss was incurred, it would be made good in other lines of production If, on the other hand, there was profit in such production this surplus would be added to the general revenue of the State, which would be spent on the common welfare of the people

With the disappearance of profit as an impelling force in production competition would automatically cease to exist, at least in the shape in which we find it today And if in the socialist society also there is competition it is of a different sort altogether and has different objectives There individuals vie with one another in producing more goods with a view to strengthen the hands of the State to provide better defence and such other facilities for the common people Furthermore, once unhealthy competition as a principle of production is discarded, most of the problems of the workimg classes are automatically solved The labour problem as such arises mainly from the desire of the capitalist to pay to the worker as little as possible The workers resent this and try to resist by taking resort to all kinds of devices, desirable and undesirable, to earn a reasonable wage But success in this line usually becomes difficult for the workers because of the spirit of competition in their ranks undermining their collective discipline and class solidarity And when the workers try to eliminate this evil of competition from their ranks by forming trade unions capitalists also combine, and in the ensuing trial of strength it is usually the capitalist class which finds itself favourably placed to carry through its point of view

All such problems under socialism would be automatically solved When the State happens to be the chief employer, it

* We have said before that socialists differ widely in their approach and emphasis Many hold similar views on this particular issue of the State agency being allowed to play a role in economic life But the Anarchists hold radically different views Socialists' attitudes towards the State differ widely For instance, while State Socialists would establish State ownership and would have the State control future production, co-operative socialists distrust the State and fear the over development of bureaucracy and would like to base their system upon the organisation of independent producers Syndicalists Guild Socialists and Industrial Unionists also hold more or less identical views on this subject. But Anarchists go to the extreme limit of holding the State to be the ultimate source of exploitation and maintain that no reasonable social order can be established so long as it exists

would give to the workers what is needed to ensure them adequate wage. In the early stages wages may not be very high. But as the socialist experiment gets into stride and all-round progress is made in that direction the wages of the working classes would rise rapidly. The socialist State being no private agency, seeking to enrich itself as the capitalist does, whatever the workers produce would, in the long run, accrue to them, either in the shape of higher wages or in the form of other concessions and facilities. Thus exploitation of workers would come to an end.

Similarly, unemployment, strikes and lock-outs and other allied industrial evils would cease to exist. Unemployment, for example, mostly takes place when either the supply of labour is more than the demand for it or when there is deliberate attempt on the part of capitalists to curtail production with a view to preventing the impending fall in prices as caused by over-production of goods. Under socialism no such contingency would arise, for the very first article of faith with the socialist authorities would be maintaining full employment. Therefore all those who are willing to work, are physically fit to work and can work on the prevailing rates would be provided with work. There may be unemployment of a temporary nature, caused by a change-over from one line of production to another or as occassioned by similar other short time factors. But in no case can there be any such thing as long time or permanent unemployment. Similarly, strikes and lock-outs would have no place in a socialist order.

The main objective, it may be emphasised again, before such a society would be to employ all men and materials available in the country and with their aid to concentrate primarily on the production of necessaries of life so as to provide all a reasonable standard of life. And after all the people have had a substantial measure of these necessaries efforts would be made to produce comforts and luxuries. Thus under socialism there would be ever increasing avenues of employment. And, finally, if any such stage is reached when with the aid of highly mechanised forms of production all the good things of life have been produced and still there are some people in need of employment then hours of work would be curtailed. In fact, a measure of curtailment of the average hours of work would be necessary even in the beginning of the socialist experiment. And this reduction in work would become even more pronounced in later stages, for the ideal then would be to provide employment to each and all, even if such employment means work only for an hour or so per day. Certainly such an arrangement

would be infinitely better than the present one in which, while a large number of people remain unemployed, others have to work so long and hard that their health and lives are seriously impaired

One of the most serious indictments of the capitalist civilisation is that it produces appalling inequality of incomes in its various economic and social groups As one knows, such glaring inequalities mostly arise from the fact that while a small number comes to own production the vast majority are reduced to the status of mere hewers of wood and drawers of water Socialists are strongly opposed to such gross inequalities, they maintain that when the task of production is taken over by the State the possibility of such inequality would not arise and this problem would be solved without much difficulty

One may, however, object that the ownership of production is not the only factor which causes inequality of incomes Unequal salaries and wages also can and do cause a measure of inequality Socialists for this reason do not believe in paying grossly unequal salaries or wages to different classes of people In an ideal socialist society, therefore, people would not be paid according to their work but they would get according to their needs When such becomes the order of things inequality of incomes would automatically disappear But socialists do realise the necessity of paying in the transitional period different salaries and wages to different classes of workers, for they rightly think that if some such compromise is not accepted as a temporary measure production might be adversely affected in the initial stages of the socialist experiment As human nature cannot be reformed at one stroke, they accept this an important compromise with their high principles But even such inequality as is likely to be caused by paying unequal salaries they seek to reduce by adopting progressive taxation as an important principle of public finance

Smaller Reforms

Besides, there would be scope for smaller economic and social reforms as well For example, in modern times, when adequate necessaries of life have not been produced, superfluous and even harmful goods are produced, for the production of such goods is found to be more paying than the production of necessaries Such a contingency under socialism would not arise The socialist authority would produce only such goods as are socially necessary and useful Goods needed for making life comfortable would also be produced, but they would be produced only after the necessaries of life have been turned out in adequate quantity In other words, under socialism first

things would come first and most strict adherence to a social and ethical priority would be observed.

At present vast funds are spent and squandered away on advertisements and in organising sale publicity by competitive producers, who want their own goods to sell in preference to rival goods produced by others. Considered from the social angle such expenditure is net waste. When the total supply of goods happens to be less than the total demand for them there is no wisdom or reason in wasting large resources, financial and other, on organising sale publicity. As in the socialist society there would be no competing producers the question of wasting such large resources on advertisements would not arise at all. The socialist authority, keeping in view the choice and preferences of the consuming public, would try to produce only such goods as happen to be generally in demand and the consumption of which is not likely to harm the people. Incidentally it may also be mentioned that the modern practice of adulterating commodities and drugs, which has become a habit with unscrupulous producers, can have no place in the socialist scheme of things.

Moreover, as is so well known, in a crisis our industrialists have to destroy a good part of what they have produced, when there is danger of a drastic fall in prices. Thus, while millions of people are hungry and naked, large quantities of socially useful and necessary goods are delibetrately and remorselessly destroyed. Similarly, in order to get the best returns from the exitsing capital investment, industrialists try to suppress scientific inventions on which they have often spent millions. If the invention or discovery in question turns out to be of such a revolutionary nature that in order to accept and introduce it the industrialist concerned has to pull down his entire industrial superstructure then he prefers to keep that scientific formula a sealed secret for a long time or for ever. In consequence of such practice, which is not uncommon, humanity is cheated of its advancing wisdom and prevented from deriving any benefit from such scientific inventions. This is, however, only one aspect of the tragedy. The other aspect is that if a person, who is new to a business, comes across some such invention as is likely to curtail the cost of production drastically, he would readily adopt it and thus indirectly compel rival producers to write off their entire industrial equipment, if they want to exist in that line of production. Thus industrial equipment worth billions is sometimes wasted in no time because of this competitive factor. Society suffers as a result of both these

situations When, however, State comes to be directly responsible for production as would happen in a socialist society, these forms of social and economic waste would be conveniently avoided

How it will Happen

All this seems too good to be true One may well ask who will bring about such a great change and how? In other words one would like to know the ways and means which socialists prescribe for bringing about such drastic economic political and social changes It would be interesting to know that conceptions as to the methods whereby socialist ideals are to be realised vary considerably The methods and means suggested vary with the temper and tone of the particular socialist ideology Revolutionary socialists particularly believe that the workers being the worst sufferers from the wrongs created by capitalism it is they who should organise to fight the battle for socialism In other words, they maintain that the establishment of the new society can be achieved only by a violent uprising They also hold the view that when the proletariat awakens to its historic duty and responsibility no power on earth can prevent it from achieving its objective The weapon which they prescribe for bringing about this a change is the same old weapon of strike But while thinking of world revolution they naturally have in their mind a militant general strike by international working class rather than isolated actions by local trade unions

Other schools of socialists however, hold that when strikes become frequent and general in character capatilists, in the long run, would be compelled to accept more and more the demands put forward by the working classes Meanwhile, it is believed, the democratic process would be reaching its logical conclusion, when increasing popular pressure on the State would compel it to respect the working class opinions And when Governments come to this view they would not only be compelled to make the industrialists concede the demands of the workers but they would also be led to nationalise one industry after another Thus, three factors would be operating against the industrialists First on account of the increasing pressure exercised by the organised proletariate the margin of profit would be constantly and progressively falling Second, in consequence of the desire of the democratic States to nationalise industry, capitalism would find the situation further tightening for itself Third on account of the natural tendency of the rate of profit to decline, with increase in the total quantity of capital in a country or in

the world, capitalism would be facing its own nemesis. But while these socialists believe that the logical culmination of all these factors would automatically bring about the abolition of capitalism, the other school believes in the violent overthrow by organised, militant working class. Communists generally belong to this latter school.

Establishment of a socialist society, however, will not be the end of the story, for socialism is only the means to an end—the end being the maximisation of social welfare. After the capitalist form of production has given place to a socialist one, the machinery of production, distribution and exchange will have to be re-organised in such fashion as to fulfil the promises held out by the socialists. The means which they suggest for such a consummation is Economc Planning. In the socialist society the planning authority would take the place of the private producers. The planning authority, reflecting the collective and democratic will of the people, would produce those goods which are most in demand.

Progress And Peace.

When such an ideal society has been established there would hardly be any question of exporting manufactured goods to other countries with a view to exploit their peoples. As foreign trade would then be carried on through the agency of the State only such things would be exported as have to be exported in order to make import possible. There would be no occasion of exporting finance capital because whatever capital is available in a country would be needed for the development of its own resources. Capitalists usually export such capital elsewhere in their desire to earn a higher margin of profit than they can earn at home. But when capital comes to belong to the State, the planning authiority would insist on its investment inside the country. International trade would then be carried on according to the true principles of comparative costs, and all countries would stand to gain from such trade. And when foreign trade is regulated and carried on on such rational lines chances of international conflict, at least on economic grounds, would be greatly minimised. War then would become an accident and not continue to be a logical sequence of the industrial nature of the world economy.

CHAPTER LVI

ECONOMIC PLANNING*

What is Economic Planning

In general Economic planning is the rational control of the economic forces for the attainment of a well defined objective within a given interval of time It means the arrangement of the economic resources which are scarce in relation to the demands for their alternative uses in such a way that the satisfaction yielded by them is maintained at a maximum level Economic planning involves that is to say, the element of choice between the scarce means of achieving a pre determined end It is a carefully thought correlated purposive policy

Broadly speaking the control over the economic resources falling within their scope may be exercised by individuals business firms industries or the state But it is apparent that the range of the control in the case of the first three will be narrowly limited whereas in the case of the state the control may extend over the whole of the productive resources of the country The terms that are used for the purposive arrangement of the factors of production which they command by the former are business management' and 'rationalisation' What is called economic planning refers really speaking, to planning by the state.

Of course, the state may undertake to control the economic forces of a section of the whole economy or of a region of that economy or of the whole economy This makes no difference at all So long as the control is carefully thought out is correlated and purposive it connotes economic planning

In particular But it must be clearly understood that economic planning to be effective must be of *the* economy as a whole and not *within* the economy, for the different sections or regions are the parts of one whole and cannot be segregated and planned without the whole economy being planned

*Problems concerning control of money and banking and of foreign exchanges are not treated here

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It is in this sense that economic planning is understood here—central planning of the whole economy.

Economic planning thus comprises the following essential elements. (1) It means the positing of a purpose, an end. (2) It means the positing of that purpose to be achieved within a definite time limit. (3) It means the rational arrangement of the economic resources for the achievement of the end. (4) It means the control of the productive resources subject to the plan. (5) It means the state control of the resources in place of decisions of individuals.

Types of Economic Planning

Economic planning is mainly of three types: (1) communist economic planning; (2) fascist economic planning, and (3) capitalist economic planning. The first and the second are the same in all respects except two. These are :—(a) In the former all the material instruments of production are nationalised and directly controlled by the state. In the latter ownership of them rests with private individuals, but their use is directed by the state. (b) The purpose of the former is to promote the interests of the people as a whole, particularly of the masses who are down-trodden. It is planning for the increase of general social welfare. The object of the latter is to further the interests of a minority party—the militarists. It is planning for power politics, for war and not for economic well being.

As these two types are similar in their working, they will be discussed under one heading—'economic planning'.

As to capitalist economic planning, it will be treated under an appropriate heading. Its nature, operation and scope will be pointed out there.

Why Economic Planning

The idea of economic planning is as old as the fourth century B.C., but the practice of economic planning dates from about 1918, particularly from 1928 when the first Russian Five Year Plan was launched.

Since the last World War II economic planning has become the order of the day. It is regarded as the solvent of all economic difficulties, the panacea for all economic ills. It is advocated by the socialists or communists, nationalists or militarists, technocrats, industrialists, labourites, economists and politicians not only in backward countries, but also in advanced countries, even individualism ridden countries.

The reasons for this enthusiasm are the following

1 The disappointment felt with the capitalist system because of its short comings These may be noted here in brief They are

(i) The system has resulted in awful inequalities It has helped produce a vast amount of wealth but it has failed to distribute it equally A major portion of it goes to the masters and a very small share falls to the lot of the men This means inequality which has become highly accentuated in our times

(ii) Then the system has proved inefficient It is motivated by profit only Unless there is expectation of profit from an undertaking it will not be started The consequence is that a large amount of resources both material and human remains unemployed when its employment may not prove profitable to private enterprisers There is thus a great wastage of these resources

(iii) Then again the system is subject to periodical hold ups As it produces on a large scale, for distance markets and its various enterprises work independently of one another and in ignorance of what each one of them is doing it plunges into over production at more or less regular intervals of time. The over production means an economic crisis Goods are there in huge quantities the people want them in vast numbers, but they are not sold and bought because the prices that rule are not remunerative to the producers and merchants The whole machinery of production, exchange and distribution comes to a standstill There is great unemployment and consequently distress The system is thus unstable

2 The second reason is the hope held out by the planned economy of not only doing away with these defects of the free enterprise system but also of going on better than it Although no final judgement can yet be passed on the working of the planned economy where it has been introduced and the results that have accrued therefrom yet there is no doubt that during the short period it has been at work it has helped improve the economic situation very much Both in fascist countries like Germany, Italy and Japan and in communist countries like Russia its introduction brought about a tremendous increase in output in all sections of the economy, a vast improvement in employment if not the total abolition of unemployment and a wholesome reduction of inequalities, this particularly in the U S S R It is said that but for her planned economy Russia would not have come out successful in the last World War II

3. A third reason, which, in away, is allied with the second, is the success that the planned technique of production and distribution met in countries directly or indirectly belligerent, in which it had to be resorted to. This was especially the case in the countries of the West and in the U. S. A. In these countries their economies came to be practically planned for production to meet the needs of the fighting forces and the minimum needs of the civil population. Production programmes were formulated, the available resources were requisitioned and allocated between the various programmes as best as possible through private or state agencies and the authorities after supplying the requirements of the war catered to the needs of the civilians by a system of rationing. These controls enabled the countries to tide over the situation very satisfactorily. This has led to increased faith in a planned economy. If, it is argued, regimented economy can lead to efficiency in war, why cannot it conduce to prosperity in peace?

What for Economic Planning

Economic planning has been defined above as the organisation and use of the scarce economic resources in such a way that the objective which is considered desirable is achieved. Economic planning is a means to an end, not an end in itself. What is the end that is sought to be gained by a planned economy?

The end may be economic or non-economic in character. It might be partly economic, partly political and partly social. Generally speaking the ends that have been pursued by planned economies of the last twenty years or so have been of a mixed type. They have been the following :—

1. Defence and power politics. Defence has been the aim in peace-loving countries and power politics—the desire to dominate other countries—in aggressive states.

2. Self-sufficiency and development of backward areas. Self-sufficiency which has been the professed objective of some countries has been, not unoften, a part of power politics programme. Development of backward or undeveloped regions has been the goal in order to bring those regions into line with the advanced regions as well as to meet demand for more food and raw materials especially in agrarian countries, or to tide over emergencies like depressions. They have sometimes constituted autonomous objectives for raising the material and cultural standards of the people of those regions—in particular of the farmers and the workers.

3 Full employment Full employment means two things (1) For the community as a whole it means the attainment of a due balance between work and leisure—a balance such that the fruits of the work combined with the leisure yield maximum total satisfaction (2) For each individual it means a guaranteed right to a just share in the work so long as income depends upon work and to a just share in the leisure In ordinary usage it signifies that work awaits for every one who applies for it whatever his status Implicit in this is the assumption that the work that awaits is beneficial

The same objective may be expressed as planning to raise the general standard of living

Full employment has been the aim of all planned economies not so much to increase the national wealth as to secure a psychic income' to man the income being the non-economic satisfaction they feel who have work to do and the self-esteem they imbibe as being useful members of society

4 Economic security This is also another version of full employment at fair wages—wages sufficient to support family life at a traditional standard at least Economic security cannot be felt unless employment is assured to each individual who wants it and in a planned economy each must needs want it—at a fair wage

If the planned economy is of the capitalist or fascist variety economic security will mean the securing of the following conditions

1 Full employment

2 Fair wages

3 Fair profits

and therefore fair prices rents rates of interest, etc

5 Social equality This objective which is of a non-economic nature has its origin in two sentiments (*a*) one is the resentment at the great inequalities that are the order of the day because of the ostentation of the rich They lead to the waste of national resources which they perpetrate when the trifling wants of the millionaires are satisfied and the urgent needs of the poor—their necessities—are not cared for and the undemocratic tone they impart to society (*b*) The other is the sense of justice Due to realisation of the inequitous character of the competitive system the spread of education the awakening of the masses and socialist propaganda a sense of

fair play and justice is forcing itself even upon the masters—the 'haves', and a system in which social equality would prevail is becoming the ideal to be aimed at. Absolute equality is neither desired nor feasible. Hence the society which is attempted to be brought about is one in which only such inequalities are to be permitted as will be justifiable on grounds of differences in ability. In Russia the slogan 'from every one according to his ability, to every one according to his need' has been substituted by 'from every one according to his ability, to every one according to his work'.

6. Post-war reconstruction and reconstruction for peace. This is the objective in those countries which were affected by the World War II. In them the war upset their economy and destroyed a vast amount of wealth. They are facing the problems arising out of this and are planning to solve them. The immediate problem is that of post-war reconstruction ; the long-range problem is that of reconstruction for peace. Plans are thought out or put into action to solve both.

With regard to these objectives it must be noted that it is not possible to differentiate the economic from the non-economic nor is it desirable to do so. The economic objectives have their non-economic implications. Economic planning ultimately amounts to planning in general for it necessarily alters the relationship of individuals to one another and of one class of individuals to another class by effecting changes in their relationship to the factors of production as when private property in land and capital is abolished under state economic planning. In such cases economic planning more or less comes to planning individuals—changing their habit patterns.

The economic objective may, however, be put down as full employment, raising the standard of living or economic security as these three comprise more or less the same thing. In economies planned for peace and prosperity—one or the other is declared the objective whatever be its repurcussions in other fields.

The Quality of Economic Planning

The quality of economic planning must be fairly clear from what has been said under 'What is Economic Planning'. It might be clarified further. Economic planning was defined there as the control of the whole economy in a rational and coordinated manner for the achievement of a posited objective. It should be understood that imposition of restrictions by the state or interventionism does not fall under economic planning.

In every country the state has been intervening to some extent. Now-a-days it intervenes more and more, in every field of economic life—production, occupations, distribution, investment, consumption, trading, etc. But such interventionsim is not economic planning unless it involves control over the utilization of the economic resources for a particular purpose to be attained.

The control that economic planning implies necessitates the suppression of the economic choices that are open to individuals under the existing free enterprise system. Those choices are (1) the choice of production—what to produce and in what quantities, (2) the choice of the rates of exchange—the prices at which goods are sold and purchased, (3) the choice of professions and occupations the people would follow; (4) the choice of saving and investment—how much of their incomes individuals would have for investment; and (5) the choice of consumption—what goods and how much of each the individuals would consume.

Under economic planning these choices are suppressed by the state wholly or partially. If they are suppressed wholly the control is absolute, otherwise partial. To what extent the state will suppress them will be decided by the state. But this is certain that it will not let any choice be retained that is likely to stand as a hurdle in the way of the achievement of the desired objective.

And the choices that are suppressed under economic planning are taken over by the planning authorities. The authorities decide what was governed by the decisions of the private individuals. And they decide that in such a manner that the end aimed at may be reached. The different elements of the economy are correlated with one another, thus producing a certain whole animated by certain ends. It is an order of coordinated controls of regimentation.

Controls

The kinds of control. The Control of the economic resources that devolves upon the planning authorities is of two kinds, (1) direct control, and (2) indirect control.

1. The direct control is exercised through positive administrative action like commands. It adversely affects the mechanism of the market and moves it away from the point of equilibrium. It is suited to a centrally planned economy.

2. The indirect control is effected through supplementing, encouraging or restricting the economic movements of the community. It does not destroy the market mechanism but affects only its trends. It is suitable to an unplanned economy.

Different Controls and their Need

1. *The control of production.* This is a very important control. It is sometimes needed to stabilize production of particular articles as when the state wants that the people should not use more than a certain amount of them. It is sometimes required to restrict output of certain goods as when the authorities feel that their consumption should be curtailed. Generally, however, it is intended to expand production to improve the standards of consumption of the people or to develop the country. The expansion of output may be desired in special lines or on the whole—in special lines, as of war industries in planning for war or defence, of building industries in programmes of post-war reconstruction, of capital-goods industries in schemes of industrialization, of agricultural industries in plans of increase of food grains and raw materials ; and. on the whole in planning for full employment or economie security or raising standards of living.

The control of production works on a wide field. It concerns the output of both consumption and production goods and affects, directly or indirectly, almost every domain of the economy. It will necessitate the control of prices of goods, the wages of labour, the investment of capital, the allocation of labour, the sale of commodities, etc.

2. *The control of consumption.* This is a very important control. It may be expansive, aimed at increasing the consumption of some goods or restrictive intended to reduce the use of certain goods. The former is resorted to when the people do not want to have certain goods but the authorities wish to push their use in order to carry on mass production especially when the economy is under-employed or is working at a partial capacity.

The latter is brought in to enforce increased saving when saving is particularly wanted or to effectively control prices in order to prevent competition among consumers. It is especially exercised in planning for war production or for accelerating industrialisation because then restrictions on consumption become necessary to obtain supplies for the first and to

free goods for export and resources for investment for the second It is also introduced when the authorities, in the interests of public health and efficiency, regard certain wants of the people such as those for spirits, drugs and useless luxuries, as harmful and wish to curtail or abolish them, or when they are desirous of checking the fickleness of consumers' tastes which sometimes upset best constructed plans or the 'plural voting' which the price mechanism gives to the rich and wealthy and enable them to satisfy their most trifling wants while the poor cannot get even necessaries of life

3 *The control of investment* This is an extremely important control It may be said to be the corner-stone of every planned economy In every planned economy—planned for war production or industrialisation, or full employment, there are production programmes which are to be carried out to a limit such that at it the quantity of goods produced will meet the requirements of the situation This can be done only by a rational utilisation of the economic resources This is, in a very large measure, a question of control of the rate of investment Similarly, the specialisation of industry and the concentration of industry are dependent upon the control of investment, so also is the changing of the state, the structure and the efficiency of an industry, the prevention of an uneconomic use of the factors of production by firms or of wasteful competition among them

4 *The control of professions and occupations* This is not of much significance in a planned economy The direct control in this connection is of the least importance The state does not directly dictate what professions and occupations the people shall take to except in a slave economy However it might in very special cases such as war emergency or famine resort to it—that is, it might then conscript labour and force it to do the work needed in the emergency

The indirect control of professions and occupations is made some use of The various works to be carried out are decided upon by the authorities and they carry certain definite rates of wages The workers can elect to enter any that suits them best

5 *The control of rates of exchange or prices* This is also an extremely important control It relates to the control of not only the prices of consumption goods but also of those of the factors of production—wages interest, rent and profits the last three or two where they are allowed to exist as in fascist

or capitalist planned economies. It implies, that is to say, also the control of functional distribution of income and as the functional distribution of income has a bearing on the personal distribution of income, of that income as well.

The control of prices is essential for the efficient control of production, investment and consumption. It helps bring about an adjustment between production and consumption. It enables better utilisation of the resources as when monopoly prices are controlled or prices of useless luxuries or of commodities during production for purposes of war. It ensures the stability of prices which is needed in a planned economy for stimulating investment on a proper basis. It imparts to the whole economy a sense of security which is a great desideratum these days.

The control of personal income is also an instrument of forced savings or of equalisation of incomes.

But to be successful the control must comprise control in practically all domains. It must embrace the whole course of production from the raw materials up to the point where the goods get into the hands of the consumers. If any point in between the beginning and the end is missed the control of prices may prove ineffective. Also the control of prices in one industry must be supported by control of them in other industries.

Planning in Practice

I. Stages and machinery. An economic plan represents a general view of the economy of a nation. It outlines its various branches and spheres and details a quantitative scheme for its working and execution in every branch or sector of the economy. Its essential elements are "plans consisting or decisions of policy quantitatively expressed in forms of programmes and such measures as may be necessary to ensure the performance of the programmes."

Five Stages. Economic planning in practice passes through five stages. Each stage has its appropriate machinery.

1. The first stage is the laying down of the general policy — the objectives to be aimed at and the rules for work. It is the function of the Central Government or the National Parliament.

2. The second stage is the drawing up of the Plan. This is done by the Central Planning Commission, a body of experts

instituted for the purpose The Commission frames a general plan, proceeding on the basis of a thorough and elaborate survey of the actual and potential resources of the country furnished by the Statistical and Scientific Departments of the Government

The plan embodies the objectives formulated in terms of precise quantities, quotas of output for various firms and industries to produce quantities of the factors of production to be allotted to these firms to enable them to work up to the quotas, allotments of finance, prices to be charged at different stages of production and execution, etc

Along with the Central Planning Commission there exist regional, sectional, provincial and even corporations' Planning Boards The factories and concerns comprising the economy, also prepare their own plans and forward through the appropriate bodies Planning Boards to the Central Planning Commission which has previously sent the general Plan to them

The general Plan is then carefully scrutinized by the Central Planning Commission and suitably modified in the light of the several sub plans It is then ready

3 The third stage is the adoption of the Plan This rests in the hands of the National Government or may be entrusted by it to a Supreme Economic Council called into being or existing for this end The Government or the Council will have power to alter the Plan may be not substantially

4 The next stage is the execution of the Plan When the Plan is adopted, it is announced It has then to be executed The task of executing it is put in charge of the Central Administration which gets it carried out through its provincial, regional and local branches

5 The last or concurrent stage is the supervision of the execution This is absolutely essential Bottle necks may appear and will have to be removed New situations may arise because of new data, new facts and new requirements coming to knowledge and re adjustments of the Plan might have to be made in their light Then there is the question of drawing up the succeeding plans and improving the machinery of planning in future All this cannot be done without constant supervision

The supervision of the Plan may be entrusted to the Central Planning Commission or to the Supreme Economic Council or to a special body appointed for the purpose

Besides the Central and other Planning Commissions, the Scientific and Statistical Institutes, the Administrative Department, the state might have as many other bodies as it thinks fit to ensure that the Plan goes on smoothly in every branch of the national economy. For example, it might appoint special bodies to fix the prices of the production goods and to organise and conduct the trade and commerce of the country, to allot productive resources, etc.

THE PRINCIPLES OF PLANNING

Economic planning is a regime of controls or of the transfer of the private economic choices to the planning authority. On what principles does that authority carry out the controls or make the choices transferred to it?

Questions to solve. In this connection there are, in the main, five questions to solve :—(1) How to ration the goods and services already produced among the consumers? (2) What kinds of goods to produce and in what quantities? (3) How to allocate the factors of production among the various industrial units so that the goods required to be produced may be be produced in the needed proportions? (4) What shares of the production in terms of goods or income are to go the contributors to their production? (5) What amount of the current production is to be saved for the future—that is, for investment?

Their competitive solution. These questions every economy—planned or unplanned—has to solve. The way in which the unplanned—the competitive economy solves them is stated here briefly so that the planned economy's approach to their solution to be given shortly may, by comparison, be understood.

In the competitive economy the price or market mechanism acts as their solvent. First the price mechanism helps ration the existing supplies of goods and services among the consumers. Prices of goods on the market are an index to the situation of supply with regard to those goods. High prices of goods mean a comparative scarcity of them and low prices a relative abundance. But if prices are high the quantity purchased tends to diminish and if the prices are low, to increase at a given time in a given market. Thus the supply gets adjusted to purchases and goes where it is most in demand. Equilibrium between demand and supply is affected.

Secondly, the price mechanism governs what goods shall be produced and in what proportion. Production is guided

by demand—the consumers' preferences The consumers express their preferences for different goods in the prices they offer for those goods If they offer higher prices for some goods than the prices they offer for other goods, it means that the former are wanted more than the latter The producers will consequently speed up the production of the former relatively to that of the latter and their proportion will increase as against that of the others This will happen because the producers expect larger profits from the production of the former than from that of the latter

Thirdly the price mechanism regulates the allocation of the factors of production among the alternative purposes of producing goods in the desired quantities Production is carried on by the employment of the factors of production These have their market prices like consumption goods The price of land is rent of labour wage of investment interest Large quantities of the factors are wanted in trades that are on the up move and smaller in those that are on the decline This sends up their prices in the former with the consequence that the quantities of them there increase and lowers the prices in the latter resulting in their leaving these in the prospect of getting better remuneration elsewhere Thus the price mechanism distributes the factors of production among alternative uses

Fourthly, the price mechanism determines the shares of the wealth produced that should go to the contributors to its production The prices of the factors of production act, on the one hand as a force regulating their supply and distribution among production units and, on the other hand, as rewards of those factors for the work they do The prices, that is to say are in the former case the costs of production and in the second the shares of the production in terms of income that the owners of the factors receive

Fifthly, the price mechanism decides the proportion of the current production that is to be saved for the future Capitalistic production is round Saving and investment are necessary to carry it on Both are affected by the price mechanism The price of investment is interest The rate of interest dictates saving to some extent but investment more or less, absolutely If it rises investment is encouraged, if it falls investment is held back

It might be noted that all this works on the principle of marginalism The consumers the producers, the owners of productive factors and the investors are actuated by the desire

to maximize their satisfaction and profits and incomes. These tend to be maximised when the point of indifference—the margin is reached. At that point further activity on their part stops. In the case of purchases of goods by the consumers, the point comes when the marginal utilities of their alternative purchases are equalised; in the case of the producers this happens when the marginal productivities of the factors employed in the alternative uses, are equalized; in the case of the owners of the factors of production this occurs when the remunerations they receive out of the wealth they have helped in producing become equal to their marginal productivities, and in the case of the investors this comes about when the rate of interest that is paid for their investments is equal to their marginal abstinences or pained liquidity preferences.

Their planned solution. The solution of these five questions under a planned economy may now be considered. Planned economy, it must be borne in mind, is based on the abolition of private economic choices, the socialization or direction of the material instruments of production and the control of practically all economic activity and process by the state. This means that in regard to the solution of the questions it will be the decisions of the authorities that will count and not the market mechanism, the impersonal laws of demand and supply. This is explained below.

(i) Rationing of supplies among consumers. The Planning Authorities may decide to ration the restricted supplies of goods among the consumers according to the competitive principle. This will work only if the consumers' choices are left to individuals. The consumers' preferences for different goods will then tend to fix the prices of the goods at points that will clear the market of the existing supplies. In the case of greater scarcity of some goods their prices will rise, in the case of lesser demand, the prices will fall in order that demand and supply remain in equilibrium. This is exactly the same solution as that of the competitive system—the solution by the impersonal forces of demand and supply.

If the Planning Authorities take recourse to the competitive solution, the planned economy will not differ from the unplanned economy in any respect other than this that it will be composed of socialized enterprises.

(ii) The Planning Authorities may decide to do away with the price system altogether and to ration goods among the consumers by means of warrants permitting them to receive

from authorized shops definite quantities and no more of the different goods they need This way of rationing is extremely difficult to give effect to It was resorted to in the Soviet Union in 1920 but as it produced a good deal of chaos, it was given up and the price system with a difference (explained under iii) below was introduced

iii The Planning Authorities may elect to have a modified price system This is the best thing to do and it serves the aims of the authorities successfully This consists in fixing the prices of goods sold at the shops If at those prices, the consumers guided by their preferences buy the commodities in such quantities that the supplies of them are exhausted, well and good demand and supply will balance But if this does not take place some supplies are left unsold the authorities either reduce the price or raise wages to induce the consumers to buy more and thus deplete the market of the existing supplies

If any particular goods which, for one reason or another, the authorities want the people to buy and consume are not disposed of, the authorities compel the people to buy certain fixed quantities of them along with others, at suitably fixed prices in order to attain desired end

This modified price system of rationing the goods may be supplemented by a system of rationing by cards which will permit definite quantities of certain articles and no more to be purchased at the prices charged for them

Rationing by cards is introduced when there is a great shortage of supplies so that every one may have a certain necessary share of the goods The method is also taken advantage of by the authorities to favour certain sections of the community and to penalize others—the former being those who are specially helpful and the latter those who are recalcitrants or regarded as opponents When this is done, the cards will permit higher rations to the first group and lower rations to the second

What goods to produce and how much of each of them to produce In connection with this the Planning Authorities have to decide whether they should produce and in the required quantities the articles which the consumers *want* or which they *need* If they act according to what the consumers want, they will have to guide production on lines that the consumers' preferences dictate as indicated by the prices the consumers are offering or are likely to offer for different goods If they go by what the consumers need the authorities will have to draw up a scale of public or authoritative preferences and produce those goods and in those

proportions which this public scale warrants. The scale will take into consideration the private individual preferences as much as the authorities think fit, but will make full allowance for the political, social, educational and cultural aspects of the thing in the future set-up.

As economic planning pre-supposes a correction of individual tastes, the Planning Authorities will more likely than not, apply to the solution of the question 'What to produce and in what proportions' the scale of authoritative preferences.

It should be noted that the decision with regard to production will be two-fold. The first will concern the manufacture of those quantities of consumption good that have been approved for current consumption and the second the production of capital equipment for raising future standards.

Allocation of the factors of production. When the goods to be produced in such proportions as approved have been decided upon, the question of allocating the requisite productive resources among the various industrial units that are to produce them has to be settled. This is nesessary so that the production may be executed with the least cost. The authorities solve the question by direct decisions as to the proportions of the productive resources that are necessary to allocate to the firms to enable them to carry out the production plans as laid down. This is to say that the allocation is made as the authorities see fit, of course, after the experts on the matter have been consulted. If they think that more of land or capital or of both is needed in one industrial unit than in another they will allot more to the first than to the second and will do the same in regard to labour as far as possible.

Land and capital are easily allocated in this way as the government has complete control over them. But owing to the property in themselves remaining, to a very large extent, vested with the workers, the direct method of allocation cannot be applied in their case unless responsive cooperation is forthcoming from their side or they are by temperament submissive. The Planning Authorities, therefore, have to rely on the price mechanism to effect their allocation. The necessary rates of wages are offered to attract them into the various works and thus the requisite supplies of workers of different categories tend to get distributed among the various enterprises and concerns. The principles on which wages may be fixed will be given later. The principle here hinted at according to which the allocation of labour takes place is that of efficiency and scarcity or market mechanism.

It deserves to be noted that in a planned economy, at the back of all principles is the power reserved to the authorities of industrial conscription compelling individuals between certain age limits in times of national crisis, to work wherever wanted. Also it should be noted that appeals to the patriotism of the workers and awards of honours and titles are not unoften resorted to to attract workers particularly those with scarce talent and ability.

In regard to production by the allocation of the factors of production it needs further to be stated that although the planned economy will expect the productive plants each to show profit or, at least to cover costs yet the existence of these plants is not dependent upon their showing profit. They will be allowed to continue to exist and be even expanded even if they are working at losses provided their continuance or expansion is considered essential in the interests of the society. Their losses in such cases will be met by subsidies from the national funds. Planned economy is not profit motivated. It is actuated by motives other than profit—desire to promote general welfare, etc.

But it should be pointed that though the industrial plants of the economy may not, separately, be running at profit, the economy as a whole must be a profitable concern over the long range, otherwise its existence is in danger.

Distribution of income The total annual income of a planned economy will include the following sources —

1 The return from national resources and land

2 The interest on capital (as an accounting cost)

3 The charge made for unestimable elements or social costs (communal consumption or public utility services) if any

4 The profits arising from the state operations from socialized enterprises

5 The proceeds of any taxation on labour income that may be levied

6 The accounting costs of the services of labour

From these sources the state constructs its budget and carries on production. The point to note is that as capital equipment, land and mines and enterprises are nationalized the returns from these, interest rents and profits go, may be as accounting items, into the pockets of the state and not to private individuals. Labour remains the only private factor of production

The total annual income is to be distributed among the following main lines of the national economy :—

1. Costs of repairs, replacements, renewals. depreciations, etc.

2. Investments—costs of extension of mines, factories, lines of communication, trading facilities, farms, new undertakings, etc.

3. The charges for items of public utility or "communal consumption".

4. Overhead charges of the state—the cost of running government departments, national defence, research, scientific investigations, etc.

5. Wages of labour. The question here is how to determine the wages of labour—the share of the national income that will go to a private factor of production. The question includes the dertermination of a wage level and a scale of wages. What the wage level will be will depend upon the proportion of the income that is set apart for meeting the charge of wages—the wage fund. The wage scale will be constructed out of the wage fund.

The determination of the wage fund is a duty of the state authorities. They will determine it by taking into account all the other items of expenditure, particularly investments for improving future standards. It must, however, be equal to the total value of consumers' goods and services released for personal consumption in a given period. If it is not so as when producers' goods industry is desired to be rapidly augmented, wages will have to be cut down or prices raised.

On the basis of the aggregate wage fund, the Planning Authorities draw up a complete national scale of wages and the fund is divided among the workers and employees in accordance with the wage scale.

The fixation of a scale of wages may be based upon a number of principles. The authorities may apply the principle of economic equality, or of the normal needs of a family, or of efficiency or scarcity , or of responsibility, or of even racial and national discrimination.

In the Soviet Union the authorities first tried to fix wage rates on the principle of economic equality, later on they applied the principle of efficiency and scarcity—"from every one according to his ability, to every one according to his work". This is in vogue there at present. In Nazi Germany the principle of racial discrimination was resorted to. Germans, Poles, Jews,

etc., were paid for the same job different wages. In Fascist Italy where authority and hierarchy were dominant the principle of responsibility played the chief role.

In some planned economies the principle of "normal needs of the family" may be adopted, workers with larger families being granted special rates than those with smaller families. In some other countries wages might be differentiated among workers on a geographical or regional basis.

Saving and investment. The sources of these in a planned economy are two—(1) socialist accumulations and (2) individual incomes.

1. The Planning Authorities expect each unit, firm, factory and concern to save a certain proportion of its profits and to deposit it in the state banks.

2. The saving and investment by individuals is generally made in response to the same type of inducements as obtain in capitalist countries. Loans are floated by the authorities and the people are urged to subscribe to them, the reward offered being a rate of interest. The rate of inducement is sometimes supplemented by the chance of winning a lottery in which the prize is either a sum of money or a privilege such as a free holiday. The rate of interest is kept as low as possible by appeals to enthusiasm and patriotism of the people.

Out of the receipts from the two sources, the Planning Authorities make advances to various enterprises for long term investment at low rates of interest or at no interest whatsoever.

If the investment funds are not sufficient, the government can through the banks issue money enough to meet the needs of the situation.

The above explanation makes plain that in a planned economy it is the decisions of the Planning Authorities that make for the solution of the five questions. Those decisions supply a substitute for the price mechanism except in the case of the allocation of labour and in the private sector of saving and investment. In both these the market mechanism is allowed to work. They fix the prices and quantities of goods produced, exchanged, invested and consumed by more or less definite schemes and keep demand and supply in equilibrium.

It might be said that though the decisions are taken without any reference to the index of price movements, yet mentally they are made on the basis of the same process of reasoning. In every respect alternatives are considered and that alternative

is selected which is likely to give the best results. Planned economy is not price-oriented but technically oriented. It carries on by direct administrative action and not by any monetary scale of values.

The stock example of centralised state economic planning is afforded by the communist planned economy of U. S. S. R.

Capitalist Economic Planning

The question here is "Is economic planning compatible with capitalism ?"

1. If economic planning is understood in the way in which it has been explained—planning of the economy as a whole—then the answer to the question is in the negative. Capitalism is an economic organization in which the material instruments of production are owned or hired by private persons and operated at their commands with a view to selling at a profit the goods and services that they help to produce. Private ownership of the means of production and free contract are the main characteristics of the system. Under it industry is composed of hundreds and thousands of firms which either work independently or are inadequately coordinated. Planned economy is an organization in which the instruments of production are either , more or less, owned by the state or completely controlled by it. Freedom of contract except in a minor sector already pointed out is absent. The industry is one coordinated, cooperating unit.

This being the difference between the two economic systems economic planning of the type discussed cannot be possible under capitalism. It needs single central control of the whole economy. That control is its pre-essential. Capitalism implies multiplicity of controls which is foreign to economic planning. To plan economically an economy must plan the allocation of all the economic resources within its jurisdiction. There must be a master plan for the whole economy. Effective planning is impossible unless the Planning Authorities have full power of control over the direction of production resources, a power of control which means the power to say : this and that plan shall be carried out.

2. If by 'economic planning' is meant , as a few think it is meant , any state intervention in the free working of the market mechanism with the intention of correcting or at least alleviating the economic ills of the society in one direction or another, then economic planning is consistent with capitalism. The state has resorted to such interventionism since the defects of the

laissez faire system shot into light and it has resulted in much good being done But to call such interventionism economic planning is wide of the mark It might be state planning but not state economic planning It might be termed state economic action It certainly modifies the conditions under which the price mechanism works out the allotment of resources, but it leaves the ultimate result indeterminate, a matter of individual decisions

Most of the schemes, entitled agricultural plans, industrial plans population plans, communications plans etc , which have appeared in cold print during recent years are of this charater They envisage the state either as a supervisory body or a body enforcing the schemes by legislation or persuation or other indirect ways while leaving the operation of them in private hands on, more or less, a voluntray basis

3 If 'economic planning' be taken as meaning, which some people do, the state control only of what might be called as key' industries, strategic points in the economy, leaving less important goods and services to private enterprise, the control of money and credit through central banking policy, the control of investment and long range arranging of public works, then also it is compatible with capitalism In fact when planned capitalism is thought of, it is to a large extent associated with these and other similar mesaures—price fixing, quota controls, restriction of acreage, etc

Mostly these varieties of controls are tantamount to interventionism In regard to them it might be said—(1) that the determination of key industries is rather difficullt and complicated wishful thinking here may drive out common sense , (2) that with less than complete control of investment there is likehood of private sector running counter to that controlled by the state authority , (3) that investment policies of private firms would necessitate a scrutiny of the proposals as to whether they are good or bad and how much funds should be invested in one industry rather than in another In consequence of these three points there will be a tendency for extension of state control to other sectors, and the implement of price fixing, quota controls, acreage restrictions etc , might be used to trende the private sector dependent upon the public sector If this is carried to its logical limit the resulting system will be capitalism in form rather than in substance

However, it may be asserted that what planning of capitalism is feasible can be attained not by direct control but by

indirect means like compensation, supplementation, stimulation, or restriction. By these means only can the state regulate the movements of hundreds of thousands of independently working or inadequately coordinated industrial units of an unplanned economy so as to achieve results more or less approaching those gained under a planned economy.

This is so because under capitalism the government suffers from one serious handicap which is that there is no single important factor that is controlled by it. Therefore, what it can do is to use indirect methods to supplement, or help or restrain the economic activity going on. For example, it cannot fully control the output of consumption goods but it can supplement or subsidize their production ; it does not undertake the large scale production of capital goods but it can promote their production by cheap or guaranteed loans; it does not fix the average prices of goods, but it can influence the general level of prices through its monetary policy and may fix ceiling prices, in case of need, of important goods; it does not control the monetary policy but it can exert pressure on it through laws affecting the note issue and through borrowing through banks ; it has no direct control over the general level of wages, interest or rent but it can influence them all in some degree by its own terms of borrowing and conversions ; it has nothing to do with the distribution of income in general but it can redistribute a large portion of it through taxation ; it does not determine wage rates but it can fix minimum wages.

And there are innumerable other devices at the command of the government by which it can re-align and re-adjust the economic processes of a society. Deserving of particular mention is the device of the control of investments including under "investments" not only investments by private corporations and subsidies to private business units, but investments in public works and in schemes of communal consumption—like those concerning education, housing, transport, sewage, physical culture, etc.

If all these measures are judiciously combined and coordinated, they will go a long way to achieving the objectives which economic planning aims at attaining—namely, full employment, reduction of inequalities, improvement of standards of living, economic security. Of course, the laying down of precise targets and hitting them within a definite time limit will not be so possible, but short of that will be attained.

Economic Planning and Economic Theory

No theory of economic planning exists. What has been done is to attempt to adapt the principles of individualist enterprise to the collectivist. On this point there has been raging a hot controversy between economists. Some hold that those principles are applicable to a planned economy, others that they are not Whether this is so or not will be clear from what is said below

Economic theory, as it exists, is concerned with the relationship between scarce means and alternative ends. It explains the disposal of scarce means between alternative ends so as to gain the best results It does not bother itself with what the ends are Their determination is a matter of the objective of economic activity, not of its carrying on or performance with which the disposal of scarce means is related

In the capitalist economy the ends (a scale of values) are determined by the consumers' preferences for different commodities. These decide as already pointed out, the quantities of those commodities which relatively, will be produced The producers, guided by those preferences allocate the scarce factors of production between alternative uses in such a way that the required quantities of the commodities are produced at the least cost. The end of economic activity in a free economic order is thus presumably the satisfaction of the consumers' wants.

A planned order has also a scale of values—ends. It is dictated by more or less arbitrary decisions of the Planning Authorities It may be the same as in the unplanned system—the satisfaction of consumers—or any other such as social security or full employment. The scarce productive resources are allocated between the different plants so as to conduce to the attainment of these ends in the most satisfactory manner. No doubt, this is done more or less in an arbitrary fashion, but it is done with the same end in view as in the competitive organization and on mentally the same principles.

Thus theoretically and basically, the role of economic theory in a planned economy remains the same as it is in the free enterprise system. It is a matter of indifference to the theory whether the ends—the scale of values—is arrived at authoritatively or democratically. It is not concerned with the question of the determination of the objective of economic activity but with only the performance of that activity.

There is, however, a difference to be noted in this regard between the two economies. It consists in this that as the scale of values in a planned economy changes from that in an unplanned order, so the proportion of the factors of production that would be allocated would change in response to the new scale of values.

This will simply denote a change in practice but not in the part played by the economic theory. An excellent example of it is furnished by planning of production for the prosecution of a war. In a war the objective of economic activity is the supplying of the needs of the fighting forces to the maximum possible and of the civil population to the minimum necessary. To achieve the purpose the productive factors are diverted from non-defence industries to the defence industries as are so many other materials. The civilians feel the pinch of this new scale of values but the theory of Economics is not affected thereby. It has been aptly said that "the economics of war is a special study in the allocation of real means to a specific, real end".

One thing deserves to be pointed out in this context. It was said above that the decisions of the Planning Authorities as to the disposal of scarce means between alternative ends are more or less arbitrary. This is so because there does not exist in a planned economy a theoretical apparatus such as the market or price mechansim which can measure preferences and probabilities. Such an apparatus is absolutely essential for that economy to be placed on a scientific basis. In its absence economic calculation becomes difficult if not altogether impossible and the possibilities of decisions being injudicious or of a hit-or-miss variety or swayed by immediate and powerful interests, are very great or decisions that might land the economy in great and grave losses.

Conditions of Successful Economic Planning

Economic planning is not easy like going to the pictures. It is not merely a question of some sort of direction and prescription about investment of economic resources in several directions. To be a success a planned society must satisfy certain conditions. These are enumerated below.

1. The plan must be a sound plan. It must be the result of thorough and profound research, investigation and exploration of the natural resources and good accountancy. It must

be based on true facts and scientific accounting It must also have a scale of priorities If this is not so, the plan is doomed to fail

2 The execution of the plan must be in the hands of the right type of personnel The personnel must be honest and properly trained They must carry out their duties with a full sense of responsibility They must be moved by a sort of fighting spirit which is determined to be victorious at all costs

3 Proper cooperation from the side of the people must be forthcoming They must be bound together by a unity of will and purpose to make the plan a success They must regard the plan as their own and must be ready to make sacrifices or accept complusion in the general interest All this is there to the required degree when a country is on war and it is thus very easy for planning then to be successful

4 The objective of the plan must be clear and definite It must not be liable to change with change in government brought about by party politics If it is subject to change, there is no stability with regard to the plan and its smooth working is jeopardized In emergencies like war, famine, depression, the objects become clear and definite and planning moves comparatively along smooth lines, particularly during a war

5 There must be a certain degree of uniformity of wants and desires among the people or a scientific apparatus for measuring the choices of the consumers If the wants of the community are homogenous or if in the event of this condition not being fulfilled, the wants can be scientifically calculated, the amount of the goods or different quantities of different goods required will be properly estimated and planning of their production will be easy It is extremely difficult to plan for the satisfaction of a multiplicity and variety of wants without a scientific knowledge of the consumers' preferences for then goods are likely to be produced in some of which the supplies greatly exceed the demand and in others of which the demand is greatly in excess of the supplies

6 The political government must be strong enough to exercise authority, to maintain discipline among all concerned and to assure law and order in the country It must be ready to punish delinquents and dishonest officials and propagandize a sort of a common belief that the planned order will be a 'natural', a *rational* and a scientific' order, so as to inspire complete confidence in it

Objections to Economic Planning

There is nothing serious to object to except losses due to injudicious and haphazard decisions, in regard to economic planning. It offers the best solution of the short-comings of the system of private enterprise. Moreover, it holds out the promise of showing greater achievements than that system has achieved. It promises to be the chief remedy of all economic and social ailments—want, disease, squalor, ignorance and idleness.

Yet the good that flows from economic planning has to be paid for. Its price is the loss of economic freedom of individuals, the disappearance of the economic choice of production, of rates of exchange, of occupation and profession, of saving and investment, and of consumption—and its substitution by a regime of regimentation.

This is one objection that can be levelled at economic planning. And because of it some countries which prize economic freedom more than economic security and better living conditions like U. S. A. are not willing to change over from private enterprise to a planned order.

But the objection is not very serious. The loss of economic freedom involved may be more than compensated by the gain in freedom from want and idleness. In a country like America the objection finds favour because the economic security there is much higher than in any other country. In poverty-stricken countries it is not bothered about at all.

There is, however, another objection that is really of a serious nature. It lies in the risk involved in economic planning—the risk that political freedom might come to an end. Democracy is a good ideal that is held in very high esteem every where. Idealistically planned economy represents the highest type of democracy, based as it is on the cooperation of the people. But it means concentration of power, the creation of an all powerful, a Leviathan state monopolizing not only political power but also economic power. If this power falls into the hands of unscrupulous persons bent only on promoting their own or their party's interests, they might supress democratic freedom to such an extent that it will exist only in name. All types of freedom will then go—freedom to choose rulers, freedom of speech, freedom of association, freedom of religious belief, etc. etc.

This risk, it must be repeated, is political rather than economic in nature.

APPENDICES

APPENDIX I

PUBLIC EXPENDITURE AND PUBLIC REVENUE IN INDIA

Public Expenditure in India

Public expenditure in India has been marked by a striking growth since the beginning of the present century, particularly since the first great war.[1] The second world war brought about such a phenomenal increase in the scale of public expenditure that "for the first time about a quarter of our national income was fiscally mobilised".[2] The following table indicates the growth of public expenditure in India.[3]

Table I

(In crores of rupees)

	Central Govt.	*Provinces*	*Total*	
1937–38	86.61	86.95	173.56	
1938–39	85.15	85.76	170.91	
1939–40	94.57	89.22	173.79	
1940–41	114.18	95.18	209.36	
1941–42	147.26	103.48	250.74	
1942–43	289.05	118.18	407.23	
1943–44	441.84	153.85	595.69	
1944–45	496.71	204.28	700.99	
1945–46	484.57	218.14	702.71	
1946–47	381.48	254.65	636.13	(Revised budget).
1947–48	327.88	267.09	594.97	

In 1937-38 central government expenditure totalled Rs. 86.61 crores and expenditure of all provinces totalled nearly Rs. 87

[1] "Leaving aside the pre-mutiny period......we may say that during a period of 70 years, 1860-1930, the expenditure of British India multiplied eight fold. From 1900 to 1930 the expenditure doubled itself. In addition to this, local authorities have spent increasing sums from revenue raised by local taxation." P. J. Thomas, *Growth of Federal Finance in India*, p. 9.

[2] Dr. P. S. Lokonathan, *Transition to Peace Economy*, Eastern Economy Pamphlets, p. 11.

[3] *Report on Currency and Finance*, 1946-47, p. 65.

crores. Including expenditure by local authorities total expenditure has been about Rs. 200 crores. The total outlay of the central government ran up to Rs. 970.38 crores, during the last year of the war, that is 1944-45, while the total expenditure of the provincial governments amounted to Rs. 201.28 crores. A public expenditure of about Rs. 1200 crores is unprecedented in our history. Taking the war period as a whole the general price level was nearly twice as high as before the war so that it may be said that roughly speaking there has been a threefold increase in public expenditure. To what extent has this growth of public expenditure been accompanied by increase in public welfare?

This leads us to the study of the financial statements of the Governments of India and the provinces. A study of the above statements, however, reveals to us a scheme of classification which can hardly be said to be scientific. Several heads of expenditure without any affinity between them are grouped under a general heading which creates difficulty. As Professor K. T. Shah has pointed out "a historical study of public finance would be shorn of half its value if it does not bring into relief the first principles of public expenditure and revenues"[1] There is absolutely no reason why expenditure on education and public health should be grouped with those on jails, police and general administration when the principles governing the expenditure on nation building activities must be different from those governing the latter group of expenditures. Expenditure on agriculture, industry, co-operation and scientific departments are governed by principles different from those applying to general administration.

In order to grasp the nature of state expenditure in India, it would be best to divide expenditure under two broad classes, namely expenditure under security service and secondly, expenditure under social services. Though there are some difficulties regarding the implication of these terms, yet it is generally accepted that the expenditure on defence, maintenance of law and order, including departments of law and justice, civil administration and interest on public debt i.e. unproductive or dead-weight debt comprise the security services. While those forms of expenditure which are intended to enhance the welfare of the people such as education, public health, medical relief, scientific departments, industry, agriculture, co-operation and interest on productive debt, all these constitute the social services.

1. K. T. Shah, *Sixty Years of Indian Finance*, p. 58.

Security services. Expenditure on security services has borne so large a portion of the expenditure of the central government and provinces that it has always been a subject of strong criticism in the country. It would be more correct to state that the foreign imperialists were concerned more with keeping their empire secure than on increasing the prosperity of the people. As a rule military expenditure dominated the central government budget and if the maintenance of law and order within the country, that is, expenditures on police, judiciary together with civil administration are to be included, expenditure on security services was more than half in the period before the second world war.[1]

Out of the remaining resources debt services and Home charges had to be provided for which naturally left an extremely meagre amount for nation building services. Hence any increase in state expenditure caused great concern among the people for it was a signal for a more intense exploitation in the way of a heavier tax burden and little or no return in the shape of services[2].

Military expenditure. Military expenditure forms the most important item of the expenditure for security services. Such expenditure represents not only a heavy burden upon national budgets, but also a very considerable drain upon the total national income. The following table indicates India's defence expenditure before and after the second world war[3].

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[1]C. N. Vakil and M. H. Patel, *Finance under Provincial Autonomy*, page 43. " The remarkable feature of India's expenditure is that security services absorb revenue as high in proportion to her wealth as in the case of Western nations. On the other hand her expenditure on social services lags far behind Western standards and in fact is non-existent in some directions."

[2]" While increased expenditure under popular control...has helped to bring increased strenghth and security to the nations, and increased enlightenment and prosperity to the people, our continually increased expenditure has, under autocratic management, defective constitutional control and inherent defects of alien domination, only helped to bring about constantly increasing exploitation of our resources, has retarded our national progress, weakened our natural defence and burdened us with underfined and indefinite financial liabilities."

Written evidence of G. K. Gokhale before the Welby Commission 1897.

[3]*Report on Currency and Finance*, 1946-47, p. 65.

Table 2

Year	On capital account	On revenue account	Total (A)	Per cent of defence expenditure (revenue account) to expenditure	Recoverable war expenditure (B)	Per cent of B to A
1937–38		47 22	47 22	54 5%		
1938–39		46 18	46 18	54 2		
1939 40		49 54	49 54	52 4	4 00	8 1%
1940–41		73 61	73 61	64 5	53 00	72 0
1941–42		103 93	103 93	70 6	194 00	186 7
1942–43	52 51	214 62	267 13	72 3	325 13	121 8
1943–44	37 46	358 40	395 86	81 1	377 87	95 5
1944–45	62 33	395 49	458 32	79 6	410 84	89 6
1945–46	35 09	360 23	395 32	74 3	374 64	94 7
1946–47*	2 00	238 11	240 11	62 4	51 62	21 5
1947–48†		188 71	188 71	57 6		

The above table indicates that the military expenditure which occupied the most dominant position in the central government budget previously outstripped all records during the war Defence service before the Great War of 1914 accounted for nearly two fifths of the budget From 29 84 crores in 1913 14 it rose by leaps and bounds during the war, to 67 38 crores in 1920-21 or 51% of the budget. Reductions in army expenditure as a result of fall in prices and introduction of economies brought it to 39% by 1925 26 By 1928 29 it again climbed to 45% In 1936 37, according to official estimate it rose to 54% of the central and 29% of the combined central and provincial budgets

The army in India was maintained not so much in proportion to the needs of national defence and integrity of the country as in accordance with the requirements of the defence of the empire The weight of the military burdens of the em

* Revised estimate

† Budget estimate

pire was increasingly thrown on India as is evident in the proportionate increase in the figures of military expenditure.[1]

The rate at which military expenditure increased during the second world war revealed the colonial dependency of India more than ever as the country was dragged into the war without the consent of its people. India spent more than Rs. 458 crores in 1944-45 on her defence which was nearly 10 times its pre-war expenditure. Besides spending on her own defence, Government of India incurred expenditure on behalf of His Majesty's Government. The figures under 'Recoverable War Expenditure' in table 2 indicate the extent to which goods and commodities were supplied for the British and Amercian troops stationed in India. The total ran to Rs. 1739.73 crores for the entire war period which was 99.8% of our enormous defence expenditure.[2] Accumulation of sterling balances is mainly connected with this circumstance. According to the financial arrangements entered into between His Majesty's Government and Government of India the latter undertook to defray the former's rupee expenditure in India and pay in rupees for the commodities and services supplied, while His Majesty's Government agreed to pay the full value in their own money, that is, sterling. This sterling was deposited in London and credited to the Government of India or the Reserve Bank, and the Reserve Bank issued rupees against such sterling balance in payment for goods received by His Majesty's Government.[3] The printing of notes in such enormous quantities brought about a growing depreciation of money and a continuous rise of prices all round and a steep rise in the cost of living to the extent of nearly $2\frac{1}{2}$ times the pre-war

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1.

	Military expenditure in £ millions 1913	1928	1913-28 Increase per cent
Great Britain	77	115	49
India	22	44	100
Dominions	9	12	33
Total	108	171	57

From Eastern Armaments Supplement, Oct 19, 1929, quoted by R. P. Dutt in *India Today*, p. 443.

2. *Report on Currency and Finance*, 1946-47 page 65.

3. " The sterling balances accumulated at one end while at the other India parted with goods without getting anything in return. The balances instead of measuring India's wealth, measure the amount of forced tribute taken by Britain from India." B.T. Randive, 'India's Sterling Balances' an article in *Marxist Miscellany*, Vol 2.

level [1] India s defence expenditure during the war thus proved an unbearable burden to the impoverished millions of the country It could not but bring about economic dislocation with its consequent effects of famine epidemics, heavy mortality and physical deterioration of the people in general

India s defence expenditure in the postwar years has not shown an appreciable fall According to the budget estimate of 1947 48 defence expenditure still forms 57 6% of the total expenditure in the country The situation in the United King dom and the United States may be said to be not very different to that of India In the former country instead of more re sources being applied to the capital re equipment upon the most urgent needs to raise productivity, the only effective offset in the sphere of foreign trade the pace of demobilisation has been lessened and unproductive expenditure on armed forces is left almost untouched[2] In 1948, 66 3% of the total federal budget in U S A will be appropriated for the defence services The increasing militarisation of that country is a soruce of deep concern to every peace loving citizen[3] In this respect the condi tions in U S S R present a contrast Military expenditure in that country has been reduced from 23 9% in the first post war year 1946 to 17 5% in 1948 Unless India breaks with its former imperialist traditions, now that transfer of powers has taken place, and switches over to the long term tasks of economic reconstruction and mobilisation of resources in a most effective manner to remove the age long poverty and misery and under-employment in the country the Dominion Government will

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1 Index numbers as issued by Economic Advisor to the Government of India

	General index	*Food articles*
1939-40	125.6	
1940-41	114 8	106.5
1941-42	137 0	122 1
1942-43	171 0	174 6
1943-44	236.5	263 4
1944-45	244 2	232.9
1945-46	244.9	237.0
1946-47	275 4	256 8

2 M Doble Deflation and the Economic Crisis an article in *Labour Monthly*, January 48

3 *The present trend* towards military control over American life and institutions should therefore be of the deepest concern to every patriotic American It would be fatuous and suicidal for us to assume that we can adopt ways that have corrupted and destroyed other civilisations and ourselves escape the same fate *New Times*, March 3, 1948

subject itself to the same criticism which was levied against foreign rule in India.

Next to military expenditure are the expenditures on general administration, police, jails and justice which are included in the security services expenditures. While defence service is a central government function, the above functions are mainly the responsibility of the provinces. It is important for us to note that it has been the conscious policy of the imperialist rulers to carefully exclude the above subjects from the hold of responsible ministers or impose restrictions, even though they conceded constitutional reforms. The legislative act of 1919, which gave limited responsibility to the provinces classified subjects into 'reserved' and 'transferred' subjects. While development departments for which there was no money were transferred to the Indian ministers the more strategic subjects such as general administration, police, administration of justice and jails, and finance were reserved in the hands of the ministers responsible to the Governor. The Act of 1935 too, did not make any fundamental change. Defence among others was under the sole control of the Governor General, while civil service and police were under the charge of the Secretary of the State. Salaries were not to be voted by the legislature.

The following table shows the expenditure of security services in the provinces[1].

Table 3.

Figures in crores of rupees

	1937-38	1938-39	1939-40	1940-41	1941-42	1942-43	1943-44	1944-45	1945-46
General administration	12·0	12·12	12·39	12·24	12·68	13·42	15·02	17·52	22·18
Administration of justice	4·91	4·91	4·87	4·83	4·88	5·05	5·49	5·99	6·79
Jails and convict settlements	2·19	2·04	2·22	2·46	2·77	3·49	5·78	4·89	4·94
Police	11·15	11·15	11·54	12·06	13·01	16·63	19·80	21·84	25·50
Total	30·25	30·22	31·02	31·59	38·34	88·59	46·09	50·24	59·41

Expenditure on security services in the provinces absorbs nearly about 1/3 of the total expenditure[2] with the result that even though the provinces are responsible for the nation building

[1] Finance and Revenue Accounts of the Government of India.

[2] It ranged from 20 to 41% in the different provinces in 1939-40, according to C. N. Vakil in *Finance under Provincial Autonomy*.

activities of the country and increase of economic welfare a large portion of its resources is spent on the primary function of the state

The cost of maintaining some of the foreign embassies and the emoluments to the Governor General[1] are at a high level This certainly cannot be said to bear any reasonable proportion to the general level of incomes in the country, neither can it be sanctioned by the best traditions of our struggle for freedom

The top heavy structures of the administrative service, as is usually the case are purchased at the cost of miserably low salaries in the clerical branch and other subordinate staff The claims of this class of public servants have never been sympathetically considered till lately by the Central Pay Commission which undertook a comprehensive enquiry into the public services of the country Until now every royal commission that has been appointed to investigate into the grievances of the public services or every reform that has been suggested or carried out in consequence has had reference to superior posts only[2]

Law and order Administration of law and order has assumed immence importanse during the period While expenditure on general administration increased by 83%, that on police recorded an increase of 135% (table 3) As stated before, the reforms of 1935 placed police along with civil services under the control of the Secretary of State, outside the purview of the legislature Their rights and conditions of services were protected by special provisions, and the Governor General controlled absolutely the secret police

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[1] Prime Minister Nehru replying to a question in the Dominion Parliament on August 31, 1948 gave the following details about the Governor General s establishment —

	Rs.
Governor General s salary	20 900 per month
Sumptuary allowance	3,750 ,, ,,
Expenditure from contract allowance	29,166 , ,,
State conveyance and maintenance of motor cars	5,250 ,, ,,
Cost of establishment	50,500 , ,
Total	1,99,566

[2] K T Shah, *Sixty Years of Indian Finance*, p 109

Thus there has been an increase of Rs. 29.16 crores for security services apart from military expenditure, and the expenditure per head of population increased from Rs. 1-0-4p in 1936-37 to Rs 2-0-2p in 1945-46.

Social service—We now come to our second classification of expenditure on social or development services in India as mentioned before. This is that important branch of public expenditure which enables the public authorities to bring about a change in the economic welfare. The most notable feature of India's public expenditure is that although security services absorb revenue as high in proportion to her wealth as in the case of western countries, the expenditure on social services lags far behind western standards and is in many cases non existent.[1] The following table gives a comparative picture of the expenditure on social services in India as compared to some other countries for the year 1933-34.[2]

Table 4.

	Total exp. in millions	Exp. on social service in millions.	Percentage to total exp.	Per head exp. on social services. Rs. as. p.
United Kingdom (£)	778	201.8	25.9	57-15-10
France (francs)	49,8811	662.0	13.3	16-14-11
Germany (marks)	6,189	1372	22.2	13-9-7
Australia (£)	64.7	11.3	17.5	22-8-6
Canada (dollars)	448.5	49.7	11.1	15-3-2
India (Rs.)	2053	17.5	8.5	0-10-5

1. Social security provisions either in the way of social insurance, or social assistance have been practically non-existent in the country, with only two items covered so far—workmen's compensation and maternity benefit,

2. C. N. Vakil and Patel, *Finance under Provincial Autonomy.*

The following table shows the expenditure on social services in India[1]

Table 5

Figures in crores of rupees

	1937 38	1938 39	1939 40	1940 41	1941 42	1942 43	1943 44	1944 45	1945 46
Scientific depts	71	71	68	71	72	61	61	1 36	1 31
Education	11 92	12 44	12 73	13 05	13 44	13 73	14 77	16 86	19 46
Medical	3 74	3 18	3 92	4 13	4 14	4 28	5 44	6 62	7 83
Public Health	1 83	1 87	1 82	2 19	2 17	2 44	2 39	3 72	4 97
Agriculture	[illegible]	2 29	2 42	2 95	3 19	4 65	6 89	9 68	10 11
Veterinary	4	6	63	[illegible]	71	75	37	1 08	1 42
Co-operation	72	67	35	81	91	93	93	1 16	1 55
Industries	14	85	09	12	19	25	24	72	1 27
Aviation	21	30	35	79	91	1 16	67	54	41
Broadcasting	14	21	25	30	80	61	58	65	78
Total	22 67	28 89	23 86	25 85	27 18	29 45	33 45	42 39	48 11

Social services came under the category of 'transferred' subjects and were the responsibility of the provinces The contrast between expenditure on security service and social service is striking While the net increase on security services during the period 1937-38 and 1945 46 was Rs 29 6 crores the net increase on all the social services taken together in the same period was Rs 25 44 crores The expenditure per head for social services which was 12 as in 1937-38 increased to Rs 1-9 as 6p in 1945 46

Education Education has the largest share of the total expenditure under social services From Rs 11 92 crores in 1937-38 it increased to Rs 19 46 crores in 1945-46, a net increase of Rs 7 54 crores which stands in marked contrast to the increase in expenditure on police which was Rs 14 35 crores during the same period (refer to table 3)

1 *Finance and Revenue Accounts of the Government of India*

One of objects of the Anglicised system of education as initiated by Macaulay[1] was to train a number of people who would fill the offices and serve British interest. Such a system introduced in the interest of efficient administration, could not naturally serve other puposes equally well. In 1911 illiteracy which extended to 94% of the population, in 1931 still extended to 92%. In twenty years time 2% of illiteracy was removed. The latest census figures which reveal that only 120 out of every 1000 people are literate indicate scarcely any improvement in the situation. In western countries female education stands almost on a par with the male, the figure for literate females in India is not more than 2%[2].

A characteristic feature of the education system in India is the meagre provision of technical training, a vital need for an undeveloped country. Education in India has not trained the young and the old in the use of modern tools and machinery. There were altogether 85 professional colleges in the country which trained students in engineering, agriculture, commerce, veterinary, medicine and the legal profession with an enrolment of 36,306 in 1945-46, while the number of technical specialists alone who graduated in the Soviet Union in the single year 1937 was 45, 900.

The responsibility of primary education in the country rests on the local bodies, the municipal and the local boards. Neither the central government nor the provincial governments have accepted full and direct responsbility for mass education. Public expenditure on education therefore must also include the expenditures of local bodies in this direction[3].

While elementary and secondary education is given free in the publicly maintained schools in England,[4] and the States in America make a similar provision, secondary education is not generally given free in India, where it is most necessary that it

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1. Macaulay's Minute of 2nd Feb. 1335 regarding educational policy is a document of great historical importance, for it was largely responsible for introducing English education in India.

2. United States Office of Education records in 1943-44, say that there were 13, 332, 723 males and 13, 760, 470 females in the schools and colleges of United States.

3.

Expenditure on education.	1937-38	1938-39	1939-40	1940-41	1941-42
From local funds	2,53,80	244·22	2,4294	2,7144	2,6327
From municipal boards.	1,73,29	174·15	1,76,20	1,90,21	1,89,85

4. Fees in all types of secondary schools maintained by local authorities were abolished on 1st April, 1945.

The expenditure per head of population on medical and public health services by public authorities including local bodies amounted to 8 as in 1940-41

Nearly 2/3 to 4/5 of the expenditure under social services is appropriated by education, medical and public heatlh services The remaining expenditure is spread over scientific departments, agriculture, co operation, veterinary, industries and broadcasting, nation building departments utterly neglected and starved

In conclusion , public expenditure in India under British rule was predominantly directed in assuring the security of the Indian Empire against external agression and internal disorders and was little concerned in increasing the economic welfare of the country It is now in the hands of our national governments at the centre and in the provinces, while keeping the principle of maximum social advantage in view, to correct the lack of balance between the two classes of expenditures security service and social servi c and to so effectively utilise the weapon of public expenditure as to revitalise the country and to make it throb in all spheres of economic life

Public Revenue in India

The growth of modern system of public finance in India has been slow Our financial system did not compare well, at least up to the first world war, with the financial systems of the progressive countries in the world The total amount of public expenditure was not very large and the method of spending it evoked sharp criticism from the people The sources from which the revenue was collected discriminated against the poor and the tradition of centralised administration of the finances dis couraged the growth of initiative and a sense of responsibility amongst the people Various causes have been assigned for this state of things But they were primarily due to historical traditions, economic backwardness of the country and political dependence of our people

But during the inter-war period, with the economic progress of the country and the constitutional development, our financial system has recorded considerable progress Not only has the total amount of public expenditure and, along with it, the public revenue vastly increased but also new items of expenditure and sources of revenue have been added Moreover, our people have come to exercise now a great deal of control over the state finances particularly in the provincial sphere

The coming of the second world war accelerated the forces which were already in operation. Today not only the governments, both at the centre and in the provinces, have their budgets much larger than what they were in pre-war days, but our people through their elected representatives are in complete control of the finances of the country, in the provinces as well as at the centre.

In this chapter we shall study the question of public revenue in India. Indian public revenue has been classified in various ways. But the most important for our purpose is to classify it as it belongs to the different grades of governments—central, provincial and local in this country. We shall take up for our study the central and provincial revenues only.

The following table shows the revenues of the central and provincial governments since 1937-38.

(In crores of rupees)*

	Central		Provincial	Total
1937-38	86.61		89.44	176.05
1938-39	84.52		87.74	172.26
1939-40	94.57		90.83	185.40
1940-41	107.65		97·48	205.13
1941-42	134.57		107.41	241.98
1942-43	176.88		124.31	301.19
1943-44	252.06		163.31	415.37
1944-45	335.57		208.18	543.75
1945-46	360.67		229-33	590.00
1946-47	336.17	(Revised Budget)	243.07	579.24
1947-48	178.77	,,	——	——
1948-49	255.24	(Budget estimate)	242.77	498.01

Note—Figures up to 1946-47 relate to undivided India. Figures for 1947-48 relate to the revised interim budget of Indian Dominion for 7½ months only.

The main sources out of which the central and provincial governments get their revenues may be classified as follows :—

*Reports on currency and Finance for 1946-47 and 1947-48.

(1) Custom Duties, (2) Excise Duties, Central and Provincial (3) Taxes on Income, (4) Land Revenue, (5) Stamp Duties, (6) Revenues from Railways, Post and Telegraphs, Currency and Mint Irrigation, Forests etc, (7) Revenue from Salt and Opium

Central revenues Before the budgets of the central and provincial governments were separated in 1921 there was only one budget for the whole of India and all the important sources of revenue and the powers of taxation belonged to the central government But with the separation of the budgets the sources of revenue were also separated Further changes were made by the Government of India Act 1935 according to which important sources of central revenue are as follows —

(1) Customs, including Central Excise (2) Taxes on income other than agricultural income, (3) Salt (4) Opium (5) payments by Indian states (6) Railway Receipts (7) Receipts from other Central Departments, such as Posts and Telegraphs, Civil and Military departments, and Currency and Mint (8) interest on money lent The following table shows the yield of the three important heads of central revenue for a selected number of years

(In crores of rupees)

	Customs	Central Excise	Income Tax & Corporation Tax	
1921 22	31 6	2 9	18 7	
1925 26	42 6	3 2	15 9	
1929 30	47 5	3 8	16 7	
1933 34	39 9	7 2	17 1	
1937 38	43 1	7 7	14 6	
1941-42	37 9	13 2	36 7	
1943-44	26 6	24 9	109 7	
1944 45	39 8	38 1	164 7	
1945-46	73 6	46 1	149 3	
1946 47	87 5	42 8	127 1	(Revised budget)
1948 49	80 8	46 0	101 0	(Revised Estimate)

Note—Figures up to 1946 47 relate to undivided India From the figures of the last column provinces' share of the income tax has been excluded

Custom Duties. Custom duties include both the import and export duties levied by the central government and up to 1941-42 they were the largest single source of central revenue but since then income tax has become the most lucrative source of central revenue. Until 1924 India was entirely on a free trade basis and import duties which were levied were solely for the purpose of revenue. But with the adoption by the government of the policy of discriminating protection import duties have begun to be used for giving protection to a number of home industries. For the purpose of import duties imports are classified into a number of categories and different rates are charged for different categories of goods. During the second world war return from custom duties declined considerably. But in the post-war period with the improvement of the foreign trade yield from custom duties is again increasing.

Central Excise. These are the taxes levied on a number of articles produced within the country such as sugar, kerosene, oil, motor spirit, matches, silver, steel ingots, tea, coffee and vegetable ghee. Before 1941, there was a smaller number of articles on which excise duties were levied and the purpose of these duties was to recoup the financial losses suffered by the government in the fall of custom duties in giving protection to such articles specially sugar and matches. But from the outbreak of the second world war, with the object of getting additional resources not only new articles were added to the list but the rates of the formerly taxed articles were also raised high. As most of theory of sound public finance tells us, the excise duties should first be imposed on articles of luxury so that the burden falls on those who can pay it easily and also because the consumption of luxuries is not necessary from the point of view of health. After luxuries, duties should be imposed on conventional necessaries because even if their consumption becomes less as a result of the tax, the health of the people will not be affected because consumption of conventional necessaries is not imperative for reasons of health. Judged from this point of view we can say that most of the articles chosen for the purpose of this tax by the Government of India are conventional necessaries like tobacco, cigarettes, betelnuts, tea, coffee, etc. Sugar and vegetable ghee are not consumed by the poor. The article which is consumed by the poor and which has to pay this tax (thanks to Mahatma Gandhi the excise duty on salt, which was a prime necessity, has already been abolished) is kerosene oil. The government will do well to abolish this duty so that the poor may get some relief. In the future the government should

be careful in selecting commodities for purposes of excise duties

Income tax Income tax is, at present, the most important source of revenue to the Government of India In India the income tax goes back to 1860 but it is only since the second great war that it has become the most important source of central revenue The income tax in India has passed through various stages but as it exists at present the following characteristics may be noted —

(1) The tax is levied on non agricultural income The right to tax agricultural income vests with the provinces This is so since the year 1937

(2) A minimum exemption limit has been prescribed. The minimum limit has ranged from Rs 500 up to Rs 2,000 But in the budget of 1948 49 the minimum was raised to Rs 3,000, the highest so far prescribed

(3) Income tax is charged at a progressive rate Scales of progression were introduced in 1916 but rates have been revised several times A super tax on a progressive scale in addition to income tax is charged on all incomes above Rs 25,000 The following are the rates of taxation according to 1948 49 budget —

Rates of Income Tax

1 *In case of every individual, Hindu undivided family, unregistered firms etc*

On the first Rs 1,500 of the total income	No tax
On the next Rs 3 500 of the total income	One anna a rupee
On the next Rs 5,000 ,, ,, ,, ,,	2 annas a rupee
On the next Rs 5,000 ,, ,, ,, ,,	3 1/2 annas a rupee
On the balance of the income	5 annas a rupee

2 *In case of a company*

On the whole of the income up to Rs 25,000	21/2 annas a rupee
If the income is above Rs 25,000	5 annas a rupee

3 *In case of every local authority*

Rates are the same as in case of the companies

Rates of Super Tax

1. *In case of every individual, Hindu undivided family, unregistered firms etc.*

Slabs of income	Rates of earned income (as. in the rupee)	Rates of unearned income (annas per rupee)
On the first Rs. 25,000 of the income.	2	3
On the next Rs. 15,000 of the total income.	3	4 1/2
On the next Rs. 15,000 of the total income.	5	6
On the next Rs. 15,000 of the total income.	6	7
On the next Rs. 15,000 of the total income.	6 1/2	8
On the next Rs. 50,000 of the total income.	7	9
On the next Rs. one lakh of the total income.	9 1/2	9 1/2
On the next Rs. 1 lakh of the total income.	10	10
On the balance of the income	10 1/2	10 1/2

2. *In case of registered co-operative societies*

On the first Rs. 25,000 of the total income.	No tax.
On the rest of the total income	2 annas in a rupee.

3. *In case of local authorities*

On the whole of the total income	Two annas per rupee

4. *In case of every other company*

On the whole of the total income	Three annas per rupee

This shows that in case of incorporated companies and local authorities there is no exemption limit and the super tax is charged on their total income.

(4) A distinction is made between earned and unearned income and relief to the extent of one-fifth of the income is granted in the case of earned incomes in accordance with the budget of 1948-49. This new innovation first introduced in 1946 has removed a great defect from the income tax act of the country.

(5) In 1947-48 full year budget the combined rate of -/15/6 per rupee for income tax and super tax was reached on an income of Rs. 1.2 laks in the case of unearned income and Rs. 1.5 lakh on earned income. In 1948-49 this has been considerably relaxed and the maximum rate of -/15/6 is now reached both for earned and unearned income at a level of Rs. 3.5 lakhs.

(6) Since the year 1937-38 a part of the income tax yield is given over to the provinces. The amount depends on the size of the divisible pool but the share of the provinces has ranged from Rs 1.25 crores in 1937-38 to Rs. 36 41 crores (budgeted) in 1948-49.

This division of income tax (excluding super tax, corporation tax, tax on federal emoluments and tax collected from the High Commissioners' provinces) among the provinces and the centre in accordance with the recommendations of the Niemeyer Report which was submitted on April 6, 1936. Sir Otto Niemeyer recommended that fifty per cent of the income tax should be distributed among the provinces and 50 per cent retained by the centre But in case the income of the central government from the income tax and the railways was less than Rs. 13 crores the centre could retain the whole of the provincial share for a period of five years and then start releasing the same at the rate of one sixth of the retained share within the next five years so that after ten years of the acceptance of the recommendations the provinces may get their full share.

Fifty per cent of the revenue from income tax was to be distributed among the provinces on the following percentage basis : Bengal 20 per cent, Bombay 20 per cent, Madras 15 per cent, U. P. 15 per cent, Bihar 10 per cent, Punjab 8 per cent, C. P. 5 per cent, Assam, Sind, and Orissa 2 per cent each and N. W. F. P 1 per cent. Since the partition of the country and the establishment of Pakistan some provinces have gone out of India and boundaries of two provinces of Punjab and Bengal have also changed. It has, therefore, become necessary to change the original ratio prescribed by Sir Otto Niemeyer and at the present time (it has come in force since 15th August, 1947) the following is the percentage basis of distribution of income tax :

Bombay 21 per cent; Bengal 12 per cent; Madras 18 per cent; U. P. 19 per cent; Bihar 13 per cent; Punjab 5 per cent; C. P. 6 per cent; Assam 3 per cent; and Orissa 3 per cent.

(7) The income tax in India is now collected at the source wherever possible and the tax is deducted before the income actually passes in the hands of the assessee. It has become incumbent on the part of an employer to deduct the tax from the income of his servant, if his income is assessible, and deposit it with the government. Failure to do so makes the employer liable to pay the tax.

(8) Joint families in our countries are accorded a step-motherly treatment by the government as in their case the tax is charged on the collective incomes of all the members taken as one unit and is not taken separately. Thus the rate of taxation becomes quite high.

(9) Tax is charged on the total income of an individual which he gets from within or outside the country. Even those who are not the residents of the country but derive an income from India have to pay income tax on that income which they get from this country. Thus all the foreign firms doing business in India have to pay income tax in India.

(10) In our country tax is not charged on the following:—

(*a*) agricultural income,

(*b*) income from charitable and religious institutions,

(*c*) one-sixth of the income if it is saved in provident fund or paid as insurance premia,

(*d*) if income is derived from house rent, one-sixth of the income is exempted for repairs, and

(*e*) inheritance or gifts are also exempted.*

(11) One other defect in the income tax act of the country is that it does not allow abatement for marriage, children's education, upkeep of dependents, for meeting doctors' bill, and in case of maternity and child birth. In most of the advanced countries of the world relief is granted on all these accounts. There is a great need for granting abatement on all these grounds in order to make the tax more equitable.

It may be pointed out in this connection that the Government of India have passed legislative measures to impose inheritance tax or death duties as also capital gains tax. But so far they have not yet been charged as the government is

*There is a small probate duty which is charged in some cases.

busy making preparations for the levy of these two taxes When these two direct taxes are also charged, our country will have all the direct taxes which the modern governments in the world are generally imposing and our tax system as a whole will become sufficiently more progressive

Miscellaneous income Among the other sources of central revenue contributions from the railways are most important With the separation of the railway budget from the general budget in 1925 general revenues have begun to receive a definite annual contribution from the railways The amount varies according to the financial position of the railways It was Rs 6 0 crores in 1926 27, Rs 1 4 crores in 1938-39 but reached Rs 32 crores in 1944-45 and again in 1945-46 but has been budgeted at Rs 4 5 crores for 1948 49 Salt tax has been an important source of revenue and yielded about Rs 10 crores annually but the tax was regressive and was abolished in 1947 Incomes from other sources are more or less negligible The absence of a progressive measure like death duty or estate duty has been long realised and a bill to that effect has been introduced in the Dominion Parliament

During the period of the war the revenue of the central government increased to a large extent but expenditure increased even more Therefore, there was a huge deficit every year Increased income was earned by raising the rates of existing taxes and by imposing fresh taxation With the end of the war relief has been given to the tax-payers in various ways and there has been a decline in revenue The deficit still continues Demand has been made to fill up the budgetary deficit by reducing the expenditure

Provincial Revenue

The sources of provincial revenue may be classified as follows

(1) land revenue (2) excise on alcoholic liquors and narcotics or provincial excise as it is known (3) stamp duties (4) scheduled taxes (5) contributions by the central government (6) miscellaneous sources such as irrigation, forests etc. The table[1] below shows the total provincial revenue and also the main sources from which major part of it is collected for a selected number of years

1 Vide, *Recent Social and Economic Trends in India*, (1946)

(In crores of rupees)

	Total revenue	Land revenue*	Provincial excise	Stamps
1921-22	61.3	29.1	15.7	10.1
1925-26	76.8	29.8	18.2	12.7
1929-30	83.7	27.8	18.6	13.2
1933-34	76.3	25.1	13.8	11.5
1937-38	85.8	26.4	14.4	10.7
1941-42	108.7	27.4	14.2	10.3
1943-44	168.5	30.2	27.9	14.6

Land Revenue. Land revenue is the mainstay of the provincial finance but unfortunately the income from this source has remained more or less stationary all these years. This is a great defect of this tax. There are, broadly speaking, two types of land revenue system in our country, (1) permanent settlement where the land revenue has remained fixed since the year 1793 and (2) temporary settlement areas where the revision is periodical ranging from twenty to thirty years. In the temporary settlement areas there are three types of land revenue (1) ryotwari, (2) mahalwari and (3) zamindari. In case of zamindari tracts and permanent settlement areas, there is a class of middlemen intervening between the state and the actual tillers of the soil. These middlemen, called zamindars, exploit the poor ryot and charge land revenue at a very high rate from them and deposit only a fixed amount with the government appropriating the rest as profit. In the case of temporary settlement areas the governments charge about forty per cent of the net asset of the land in the form of land revenue. But the zamindars take roughly eighty per cent of the net asset and appropriate this huge profit. The governments of the country are doing well in abolishing zamindari as by this measure they will be able to remove the middlemen who make huge profits and serve no useful purpose. It will then be possible for the government to increase the rates of revenue and remove the inelastic nature of the tax.

Yet another defect of the land revenue, at the present time, is that the rates vary from province to province and even within the province. It will be better if the provincial governments agree to have some uniform rates of land revenue and levy them at a progressive rate.

* Excluding revenue due to irrigation.

It is good that the provincial governments are thinking of taxing agricultural income also. The Governments of Assam, Bengal, Bihar and U. P. have already passed legislative measures for its imposition. Other governments should also levy this tax.

Provincial Excise. This revenue is in the nature of duties and is derived from the manufacture and sale of intoxicating liquors, drugs and narcotics. This source is capable of yielding increasing amount of revenue, as was demonstrated during the period of war. But this extra revenue can be earned mostly at the cost of the health and morals of the people and no government should be willing to go that length for the sake of revenue. The present provincial governments are all wedded to the policy of ultimate prohibition. But this is to be introduced gradually and so long as complete prohibition is not attained all kinds of restrictions will continue to be enforced to discourage their production and sale. This means not only the loss of revenue from this source but also an increase in administrative expenditure for implementing the prohibition policy.

Stamp Duties. This revenue is derived from judicial and commercial stamps. These charges are in the nature of fees and the yield is not very elastic. The increase in revenue from this source has been less than 50 per cent between 1921-22 and 1943-44.

Scheduled Taxes. These are the taxes which the provinces were empowered to impose and they were further supplemented by the Act of 1935. The taxing powers of the provinces include among others the right to tax betting, amusements, professions, advertisements, sales tax, etc.

Almost all the provinces have utilised most of these taxes and only a few have not been tried. Tax on betting and amusement which was imposed by almost all the provincial governments after the inauguration of the provincial autonomy has proved very beneficial to the finances of the provinces.

Sales Tax. It is a new source of tax which the provincial governments have found it possible to impose after the decision of the Federal Court in favour of the provinces. It is also proving very beneficial from the point of view of yield and the Madras Government has been able to offset the loss of about 15 crores of rupees due to prohibition with the help of this tax. Other provinces are also earning a good amount from this tax and there are chances of further increase in it provided the tax is properly administered.

Sales tax is of two types: (1) a turnover tax imposed on all the commodities and (2) a select-commodity sales tax imposed on the sale of some selected commodities only. The tax may be multiple point when it is charged every time a sale is made or single point when the tax is charged only once no matter how many times a commodity changes hands. Both the varieties of the tax can be imposed but only a very limited number of commodities have been subjected to multiple sales tax because the effect of this tax being cumulative its total burden on the consumers is very heavy. In our country where there are a large number of middlemen this applies with greater force.

Sales tax is an indirect tax and is therefore regressive in nature. To remove this regressive nature to some extent, the governments adopt a number of measures. First, they exempt a number of commodities, generally, all necessaries for existence from this tax so that the burden on the poor may be less. Then they prescribe different rates and tax luxuries at a higher rate or subject them to multiple taxation. Sometimes they also discriminate in favour of small firms, imposing a minimum exemption limit (which is Rs. 15,000 per annum) for the turnover below which no tax is charged. Thus the smaller shopkeepers doing business on a small scale in villages are not burdened with this tax.

As regards the incidence of this tax, it may be on the shopkeepers as well as the consumers. This will depend on the relative elasticity of demand and supply of the commodity. These days when there is a general scarcity of most of the commodities, it can be safely concluded that the incidence of this tax will fall mostly on the consumers.

Most of the provincial governments of our country have imposed this tax and the last to arrive in the field is the Government of U. P. who have imposed it since April, 1948. They have prescribed a minimum exemption limit of Rs. 15,000 per annum and all dealers whose annual turnover is below that limit are exempted. They have also given a long list of articles exempted from this impost and almost all the prime necessities of life have been exempted. There are two rates of taxation—three pies and six pies in a rupee and there is a schedule listing the commodities subject to different rates of tax. The tax is single-point as well as multiple-point on some commodities but on most of them it is only a single-point tax. The government issues a license to all those dealers who are autho-

rised to charge this tax from the customers and they have to show that license prominently in their shop No one without the license can charge this tax The dealer is required to issue a cash memo at the time of taking the tax

There is some confusion in the mind of the public as regards the implications of this tax and they are not sure as to when it should be charged and when not This being the first year of its imposition the administrative machinery of the government is not yet perfect But with years to come the condition will improve and there is no gainsaying the fact that this tax has a great future not only in our province but in all the provinces of the country

Contributions from the central government Almost all the sources of provincial revenue are inelastic and inadequate as regards the growing needs of the provinces The defects of the Meston Settlement by which the finances of the provinces were separated from the centre in 1921 were realised at that time and since then there has been an agitation for adjustments in it The position was reviewed afterwards and in the Act of 1935 it was stipulated that the provinces should get certain assistance from the centre The assistance has been given mainly in the form of (*a*) sharing with the centre the income tax revenue (*b*) paying back a part of the jute export duty to the jute growing provinces and (*c*) subventions The total of all these payments increased from Rs 7 crores in 1937-38 to Rs 12 4 crores in 1941 42 and Rs 40 crores in 1945 46 and have been budgeted at Rs 40 3 crores for 1948 49 (The figures for the first three years relate to undivided India and the last one to Indian Dominion only)

Income from other sources is not very important From this brief survey of the provincial revenue it is evident that the provinces have been in great difficulty from the very beginning of financial settlements The sources that belong to the provinces are generally inelastic Moreover the provincial governments are pledged to various plans of reform which will cut down some of their existing sources of revenue in face of increased demand for it There are two directions from which the provinces can get extra revenue (*a*) Increased grants or assistance from the centre and (*b*) by tapping all possible sources in the provinces A third way out of the difficulty may also be added that is of scrutinising every item of expenditure and avoiding those items which are not essential Provinces are

already working in these matters. The centre is being pressed upon to give to the provinces a larger share of the income tax revenue and pay back to the provinces the exoport duty on other articles besides jute and the central excise revenue. Provinces, on their part, are exploiting their resources and other sources of income further. Some provinces have nationalised road transport and have plans for nationalising other important key industries and public utility services. These may be able to produce some profit in course of time.

There is not much scope for assistance from the centre at present from its existing resources with its present encumberances. Central government needs adequate resources to enable it to function as a strong and stable central government and to maintain strong defence services.

The provinces, therefore, have to fall back mainly upon their own resources. The burden of taxation in the provinces is not very high and there are a number of taxes which the provinces are yet to exploit. Agricultural income tax, general sales tax, taxes on advertisement and betting and others have been introduced only in a few provinces. There is much scope for further development.

The centre is empowered to levy succession duties or death duty, on property other than agricultural land, terminal taxes on goods or passengers carried by railway or air and taxes on railway fares and freights but the net proceeds of any such taxes levied are to be paid to the provinces. As the provinces are in great need of funds and greater demand is being made for contributions from the centre it should exploit these sources and make more resources available to the provinces.

APPENDIX 2

ECONOMIC PLANNING IN INDIA*

As in many countries, so in India economic planning is a fashion of thought. On the platform and in the press a great zeal is being shown for it. Books, pamphlets, brochures and reports have appeared which embody the views of individual thinkers, industrial magnates and the government on how the economy of the country should be reconstructed or planned.** But no economic planning worth the name has yet been taken in hand.

Need for economic planning in India—present situation. The need for economic planning in India is certainly very great and urgent. It cannot be too much emphasised. India has a topsided low level and deficit economy. About three-fourths of her population is dependent for their living on land. But her agriculture is in a very poor way. The land system is unjust and iniquitous. It is a remnant of feudalism and is characterised by the existence of parasites in the shape of zamindars and middle men who fatten on the tillers of the soil. Only about one third of the land belongs to the actual tiller. The holdings are scattered and fragmented, the average holding being not more than three acres which is absolutely uneconomic. The methods, technique and implements of cultivation are of the old type. Irrigation facilities are inadequate. Only about 23 per cent of the area under cultivation is irrigated, the rest

*All money figures in this plan are based on the rupee at approximately the average price level for the period 1931-39. The other figures are either 1939 or 1941 figures. The figures are pre-partition figures. The Plan is assumed to start in 1945.

Some of the relevant post partition figures are noted below —

		Indian Union	Pakistan	Total
Area in thousand square miles (including states)		1 220	361	1 581
Population in thousands	1941	319 016	69 987	3[illegible]8 9[illegible]
Area under cultivation (in thousand acres)	1938-39	285,943	53 483	339 4[illegible]6
Area under irrigation (thousand acres)	1938-39	456,79	18 748	64 4[illegible]7
Cultivable waste (thousand acres)	1938-39	88 462	25,016	113 478

**Reference: *A Plan for the Economic Development for India Or The Bombay Plan*, *The People's Plan* by M N Roy, *The Gandhian Plan* by S N Agarwal

depends upon the vagaries of the monsoon and rainfall. Manuring, seed-selection, rotation of crops are not up-to-date. The productivity of the soil is very low. It is the lowest in practically all the crops wheat, rice, sugar cane, cotton, etc, among Egypt, U. S. A. , China and Japan where agriculture plays an important role in the economy. The agriculturist does not get proper finance and is burdened with an unbearable debt which was calculated to be Rs. 1,000 crores in 1937. It is rightly said that he "is born in debt, lives in debt and dies in debt". Also the peasant labourer is whithout work for periods extending from 3 to 6 months.

As to the manufacturing industry, although India is industrially the most developed or the least undeveloped country in Asia yet as compared with the industrial countries of the West she is very backward indeed. No doubt, a number of large scale industries have come into being—such as cotton, iron and steel, sugar, jute, cement, paper, etc., but the industrial development of India has not been commensurate with the size of the country, its population and its natural resources. The progress that has taken place is confined, to all intents and purposes, to the consumers' goods industries. The heavy and key industries like the chemical, engineering and capital goods industries which are absolutely essential for industrial development are more or less conspicuous by their absence and the country depends for supplies of these basic goods mostly upon foreign countries. The proportion of population employed in the manufacturing industry is about fifteen percent only.

Regarding the means of transport and communication they are in keeping with the backwardness of agriculture and industry. There exist only about 41,000 miles of railways as against 1,90,000 miles in Europe minus Russia, which is equal in area to India. The mileage of roads in the country including the mileage in states is 347, 132 which is 0.18 per square mile and 76 miles per 1,00,000 of population as against 1.00 per square mile and 2,489 miles per 1,00,000 of population in U. S. A. The inland waterways, though used as much as possible for purposes of transport and communication, have not yet received due attention. This is also the case with the coastline of over 4,000 miles. Civil aviation is as yet in its infancy.

The vehicles of transport and communication are mostly primitive. Old types of boats and bullock carts ply the waterways and the roads. At the time of the outbreak of the war there were hardly 5 motor trucks for every lakh of population as

against 1,200 in U K and 3,300 in U S. A An Indian mercantile marine is badly wanted and a ship-building industry is greatly lacking

In other sectors of the Indian economy, trade, money and banking, finance, etc the situation is not what it ought to be. About 13 per cent are employed in trade and services

The result of all this is an extremely low national dividend The *per capita* per annum income in India is Rs 65/- as against Rs 1046 in U S A, Rs 980 in U K, Rs 796 in Australia, and Rs 210 in Japan The low national dividend is very unequally distributed It is estimated that less than 5 per cent of the people enjoy about one-third of it, about 33 per cent take another one third and remaining 62 per cent get the rest one-third In the rural areas where about 90 per cent of the population lives, the average *per capita* income is said to be Rs 18/- only. No wonder then that the masses are steeped in poverty. They are poorly fed, the food shortage is calculated to be 4 1 billion calories, about 48 millions ('average men') go without food and about two-thirds of the population gets on an average about three-fourths of the diet given to prisoners in jail, the quality of the food is poor, lacking as it does nutritive and protective elements. They are poorly clad, the *per capita* consumption of cotton cloth is 15 5 yds (1937-38) as against 64 yards in U S A, 34 yards in Germany, 21 4 yards in Japan and 19 1 yards in Egypt They are poorly housed, for the whole of India there is one house for every 5 1 persons, in big cities like Bobmay they get an average space of 27 58 square feet per person as against 100 sqare feet which gives the 3,000 cubic feet of fresh air considered as necessary for health, and sleep on street, pavements; in rural areas the houses are insanitary and ill-ventilated and human beings and cattle share them together The infant mortality is very high being 167 per 1,000 live births as against 48 in U S A, 58 in U K, 60 in Germany, 38 in Australia and 114 in Japan The average expectation of life is very low being 26 91 for males and 26 56 for females as against 60 60 in U S A, 60 18 and 64 10 in U K, 59 86 and 62 81 in Germany, 63 48 and 67 14 in Australia and 46 92 and 49 63 in Japan, for males and females respectively The man power is certainly vast—about 400 millions but it is poor in quality It is ignorant, untrained and undisciplined, only 14 6 per cent of people above the age of five are literate, that is, one out of every seven Indians over the age of 5 is literate

Potentialities and possibilities While this is the existing sad state of affairs with regard to the Indian economy, its potentialities

and possibilities of improvement are very great. There is no sector of the economy in which something striking cannot be done. There are abundant untapped resources that can be tapped. There are about 170 million acres of land which is 'culturable waste'. This can be made to come under the plough. The land system can be reconstructed and the parasites there eliminated. Modern scientific methods and technique, chemical manures, up-to-date implements and machinery, better varieties of seed can be used. Irrigation facilities can be increased. Adequate finance can be provided and the burden of debt lightened. Proper marketing system can be brought in. In industry, 'key' or basic and heavy industries can be brought into existence—industries like chemicals, hydro-electric power, capital equipment, motor trucks and automobiles, etc. Light industry to produce consumer's goods like medium-sized and cottage industries can be developed and encouraged especially when cheap electric power is brought to them. In communications, waterways, roads, railways, airways can be doubled or trebled. The old fashioned vehicles can be improved or replaced by the use of pneumatic tyres on cart wheels and power engines on boats. So also the money and banking and the financial system can be reorganised. Above all, the human factor—India's vast man-power—can be made awfully fit through ensuring provision of better food, proper clothing, healthy houses and necessary training and education.

All this can be done and much more. When it is done (the National Government has started doing something), the national dividend will go up a good deal and the face of things in the country will take on a cheerful look.

How to do it ?

Economic planning the way. There is only one way of doing it. That is the way of economic planning. This needs expense, mastery of detail , comprehensive vision, boldness and courage, which the central government alone can bring to bear on the task. That means masterful planning. A master economic plan for the country is , therefore, the crying need of the time—a master plan sponsored or helped by the central government.

A brief review of economic planning in India. As said in the beginning, there has appeared in India a good deal of literature on economic planning and consequently a number of schemes for the purpose are in the field which their authors hold will meet the needs of the situation very well.

The awakening of interest in economic planning in India dates from the thirties of the present century. The launching

of the First Five Year Plan in Russia, of the Hitlerian Four Year Plan in Germany, of the Rooseveltian New Deal in U S A and the success attending these were responsible for it The pioneer in the field was Sir M Visvesvaraya who in his book 'Planned Economy for India' published in 1934 stressed the need of planning the economy of India on western lines The Indian Economic Conference discussed the question at its session in 1934 35 and again in 1938 39 In 1938 the Indian National Congress appointed a National Planning Committee to address itself to the task of drawing up a comprehensive plan for the country The Committee did some work in 1939-40 But in the same year the World War II broke out, the country s resources were diverted to war purposes, also the national leaders were clapped in jail So the Committee came practically to an end and everything concerning economic planning was put in cold storage About 1944, however, when the war tide turned in favour of the Allies and the problems of post -war reconstruction began to be thought of, interest in economic planning revived It became a sort of craze The year saw the publication of al most all the important plans that are in the field The first to appear was the plan entitled 'A Plan of Economic Development for India' popularly dubbed as the Bombay plan Then came the People's Plan, the Gandhian Plan, and Reconstruction in Post War India The first was by eight industrialists of Bombay, the second by M N Roy on behalf of the Indian Federation of Labour, the third by Shriman Narain Agarwal and the last by Sir Visvesvaraya The Government also shook off its lethargy under pressure of public opinion and created in this very year a separate Planning and Development Department with Sir Ardeshir Dalal at its head The Department set up 29 Panels to determine the lines and the extent of possible development in all the important industries and to make recommendations in their connection In 1945, the Government of India annouced its industrial policy in which it pointed out the desirability of the public undertaking of certain key and essential industries and of centralised control over the rest of the period covered by the Government of India Act of 1935 In 1945 and the following years were published a number of books and brochures supporting or criticising all or one or the other of the above mentioned plans or proposing variant of them or the planning of one sector or another of the economy of India In 1946, the Planning and Development Department was abolished and the planning of industries was transferred to the newly instituted Industries and Supplies Department In the same year was appointed the Advisory Planning Board to undertake

a rapid survey of the whole field and to make recommendations in regard to the coordination and improvements of planning as well as the objectives and priorities and the future machinery of planning. The report of the Board was published in 1947; it contains valuable information on many important questions concerning planning. In 1947 came also the Birla Five Year Plan. This year—1948, a few months back the national Government of India announced its economic policy. Also this year the reports of the various Sub-Committees of the National Planning Committee have come out of the Press and are before the public.

This is all paper planning. So far as economic planning in actual practice is concerned anything very substantial has not thus far been done. Much could not be expected from the foreign rulers and even the economic policy they adumberated was in the interests of Britain more than of India. The National Government that assumed the reins of office on August 15, 1947, had , from the very start, to concentrate all its attention and energy on tackling the problems that partition of the country into Pakistan and the Indian Union, brought in its wake, problems such as those of the unprecedented cold-blooded massacres of people, the settlement of the refugees from Pakistan, the Hyderabad tangle and the Kashmir War. Some of these have luckily been solved and the others are on way of being solved. Still the Government has taken certain steps which although they cannot be called economic planning in the real sense augur well to put India on the road to a planned economy. Some of the steps are these. One step is the recent announcement of the Government's economic policy which will be aimed at more or less a compromise between capitalism and socialism. According to it the key industries will be owned and managed by the State and the State will have a good deal of control over most other industries and will help the small and cottage industries. It also premises to let private enterprise develop without any great interference for a period of ten years after which the question will be considered. Another step is the decision to abolish Zamindari in all the provinces. Bills for the purpose have been introduced in the Provincial Legislatures. The third step is the launching of the Damodar Valley Project and the Tungabhadra Valley Project which will supply water for irrigation to thousands of acres of land, and hydro-electric power to all types of industries—large and small. Still another may be put down as the proposal to set up one or two iron and steel plants of the capacity of one million tons each somewhere in

Bihar and the ship-building industry to be started under government jurisdiction.

The Important Plans

Of the several plans that have appeared in print in India special notice deserves to be taken of three only. They are: (1) the Bombay Plan, (2) the People's Plan, and (3) the Gandhian Plan. They are important because they represent three different ideological approaches to the problem of economic planning in India and lay emphasis on different methods of tackling that problem. Also they are important because the other plans are, more or less variants of these, most of them of the first.

The Bombay Plan

Ideology and principles. The Bombay Plan is the capitalists', industrialists' plan. It is wholly materialistic in outlook. Its proponents would preserve the capitalist order and plan within its frame-work. That order—private ownership, free enterprise and the profit motive—they recognise has admitted short-comings and obvious weaknesses but it has also to its credit enduring achievements. Hence what is needed is that the order should be modified and not uprooted. The authors would, therefore, plan for change but also for stability and orderly development. They lay down the following principles of planning :—1. There should be sufficient scope for the play of individual initiative and enterprise. 2. The interests of the community should be safeguarded by the institution of adequate sanctions against the abuse of freedom. 3. The State should play a positive role in the direction of economic policy and the development of economic resources.

Objective. The objective of the Plan is to double the present *per capita* income within a period of 15 years so as not only to secure a minimum standard of living but also a reasonable margin over the minimum requirements of life. The minimum requirements per head are a well-balanced diet with an energy value of 2800 calories per day, 30 yards of cloth per annum, 100 square feet of room space, facilities for maintaining a reasonable standard of health like adequate sanitation and water supply, dispensaries and hospitals, as well as facilities for education at least up to the primary stage. The margin over these is intended for the enjoyment of life and for cultural activities.

To meet all these requirements of life the Plan estimates that a *per capita* income of Rs. 135, (Rs. 74 for the minimum require-

ments and the balance for comforts, recreation, etc.), will be needed. The figure Rs. 135/- is just over double of the present *per capita* income of Rs. 65/-; it is the goal of the Plan. As population will be increasing at the rate of 5 millions per annum and will be 489 millions at the end of 15 years the doubling of the present *per capita* income will come about only by raising the present aggregate national dividend of Rs. 2,200 crores to Rs. 6, 600 crores, that is by trebling it.

Cost. The three-fold increase in the national dividend of India the Plan would bring about by an investment of Rs. 10,000 crores divided as shown under :—

		Rs. (crores)
Industry	......	4,480
Agriculture	......	1,240
Communications	......	940
Education	......	490
Health	......	450
Housing	......	2,200
Miscellaneous	......	200

Stages. The Plan is to be executed in three stages of 5 years each. In the first quinquennium the total amount to be spent will be low as the material resources and personnel available at the beginning will be comparatively small. As the Plan develops both these requisites will become available in increasing proportions and the tempo of progress will be accelerated. In the first stage the consumption goods industry will be accorded a high priority, while basic industry which starts at a moderate pace will develop rapidly in the second and third stages. Agricultural progress will be more or less steady.

Logic and methods. The logic underlying the proposals made in the Plan and the methods whereby the proposals are to be executed are indicated under *Production* to a certain extent, but much more, clearly under *Distribution* and *Role of the State.*

Production. The plan is primarily a plan of production. It gives the first importance to the development of industry. This is so because the industrial potentialities of the country have to a great extent, remained unexploited so far and adequate provision to make up this lag in industrial development would naturally mean a large percentage increase over the present level.

The industries to be developed are basic industries and consumption goods industries The former are listed as motive power, mining and metallurgy, machinery, machine tool, chemicals armaments, transport, cement, etc These should be developed first because without power, machinery, chemicals etc no industry can be established and without fertilizers agriculture cannot make any progress. The latter are textiles, glass, leather goods paper, tobacco, oil, etc These are attached second place of importance but are to be developed side by side with the basic industries so as to meet at least the essential requirements of the people At the same time are to be started small scale and cottage industries not merely as means of affording employment but also of reducing the need for capital in the earlier stages of the Plan The target fixed for industry is 500 percent increase by an investment of Rs 4,400 crores

In regard to agriculture the expenditure is to be Rs 1,240 crores It is kept low deliberately because the demand for food crops which form the bulk of our agricultural products is comparatively inelastic, even after taking into account the probable increase in population and also because it is supposed that a more than 130 per cent increase is not likely to be absorbed Still the Plan aims at agricultural development not merely to increase production generally but also to increase the production of those crops which are necessary for feeding the population This would necessitate a readjustment of the areas under cultivation of different crops Areas under commercial crops like jute tea, cotton, oil seeds etc , would have to be adjusted to the conditions of international trade Agricultural production would be increased by consolidation of holdings, cooperative farming, liquidation of agricultural debt, prevention of soil erosion, better methods of farming adequate irrigation, better rotation of crops better seeds and manure improved types of implements etc Improved methods of cultivation will be propagated through model farms started by the State The target for increase of irrigated area is 200 per cent for the number of model farms 65,000 for income from agriculture here is a 130 per cent

Concerning communications the targets fixed are an increase of 21 000 miles of railways and 300 000 miles of roads, the former connoting an increase of 50 per cent over the existing railways mileage and of 100 per cent over the present roads mileage In addition there will be the metalling of 226 000 miles of earth roads, the developing of coastal shipping and erection of more ports and harbours All this is proposed to facilitate the movement of goods and services which the increase in agricultural

and industrial production will effect. The proposed expenditure under this head is Rs. 940 crores.

As to education, the execution of the Plan will require a huge personnel trained for technical posts in agriculture, industry and trade and for general administration. The Plan therefore, provides for facilities for education—primary, adult, secondary, vocational, university and scientific as well for research. A sum of Rs. 490 crores is allocated for the purpose. The target is more or less the liquidation of illiteracy (primary) and it promises sufficient cultural, vocational and scientific education.

Proper houses and arrangements for maintenance of health are as essential for efficiency as education. The target for maintenance of health is via dispensary for every village (ii) general hospitals and maternity clinics in towns (iii) specialised institutions for the treatment of tuberculosis, cancer, leprosy, venereal diseases, etc., (iv) proper arrangements in respect of sanitation, of water supply in villages and towns. On these Rs. 450 crores and Rs. 2,200 crores respectively are proposed to be expended.

Distribution. Although the Plan lays chief emphasis on production, yet it sees all right that increased production will not eradicate poverty and raise standard of living unless what is produced is equitably apportioned among all those who contribute to it and not unjustly withheld by a few from the many. The policy that will bring about a fair distribution should have a double purpose : (*a*) to secure to every person a minimum income essential for a reasonable standard of living and (*b*) to prevent gross inequalities in the incomes of different classes and individuals.

To secure a minimum standard of living two classes of measures are proposed: (*i*) those that would raise the general level of income and (*ii*) those that would reduce the burden of individual expenditure on consumption goods and services, i.e., the cost of living.

The detailed measures suggested under the first subhead are provision of full employment, increase in efficiency, improvement in urban and rural wages, fixation of agricultural prices, development of multipurpose cooperatives and reform of land tenure. Industrial expansion will absorb a large part of the working population. Trade and other services will absorb another considerable part. Seasonal employment in agriculture is to be met by mixed farming, cultivation of more than one crop in a year and subsidiary

industries Schemes of relief like unemployment insurance might also be devised The spread of general and technical education, better organization of industries, especially small scale and cottage industries, better organization of agriculture and trade, cheap electricity, improved tools, appliances and fertilizers are bound to increase efficiency Wage rates in agriculture will increase with the development of farming A beginning in the establishment of minimum wages may be made in industries like cotton textile, sugar, cement, engineering jute, mining, etc For the principal agricultural crops fair prices would be fixed and the volume of imports controlled by tariffs or quotas Multipurpose cooperatives would help the cultivator find adequate finance, and store and market his crop The principle of ryotwari tenure should be gradually applied to zamindari areas in the whole of India and assessment of land revenue should be lowered with an exemption limit

As to reduction of inequalities, the Plan makes clear that though gross inequalities are undesirable, yet the total abolition of inequalities, even if feasible, would not be in the interest of the country It would, therefore, leave enough scope for variations in income according to ability and productivity, subject to the provision of a basic minimum

The measures for reducing the cost of living as enumerated are provision of free social services, e g , primary and middle school education, adult education, medical treatment, etc , and provision of essential utility services, e.g electricity, gas transport, etc , at low costs for domestic use and for cottage and rural industries

To a considerable extent, the measures suggested to secure to every person a minimum standard of living will help to reduce gross inequalities of income But according to it the most important method of achieving this object is direct taxation, which in effect transfers income from the comparatively richer classes of society to the poorer It, therefore, suggests a steeply graduated tax death duties and other similar measures for the purpose Other measures indicated are decentralisation of the ownership of the means of production which can be done through reform in the land tenures, widespread distribution of shares in joint stock companies, regional distribution of industries and the development of cooperative enterprise Control by the State, accompanied in appropriate cases by State ownership or management of public utilities,

basic industries, etc. will also tend to diminish inequalities of income. Provision of fullest scope to small scale and cottage industries, especially in the production of consumption goods would also lead in the same direction.

Finance The Plan is to be financed from the following resources :—

External finance		Rs. (crores).	
Hoarded wealth	...	300	
Sterling securities	...	1000	
Balance of trade	...	600	
Foreign borrowing	...	700	2,600
Internal finance			
Savings	...	4000	
Created money	...	3400	7,400
Total		...	10,000

External finance is the finance available for payment to foreign countries for goods and services imported from them and internal finance is that required within the country for the mobilization of our resources.

Role of the State. The role of the State in the national economy which the Plan contemplates, is based on a judicious combination of the principles of Capitalism and of Socialism. Coordination of general economic activity, management of currency and finance, collection of statistical and other information, and adoption of legislation to safeguard the interests of economically weak classes are some of the important functions which are assigned to the State as a matter of course. As to questions concerning (*i*) ownership, (*ii*) control, and (*iii*) management of economic enterprises what the Plan would prefer in different cases is noted. Mobilization of all the available means of production and their direction towards socially desirable ends can be adequately secured by State control. State ownership is necessarily involved in all cases where the State finances enterprise which is important to public welfare and security. State ownership will also be all right where in the public interest it is necessary for the State to control an industry but the circumstances of the industry are such

that control is ineffective unless it is based on State ownership Armaments posts and telegraph will be both owned and managed by the State Enterprises owned wholly or partially by the State like public utilities basic industries, monopolies, industries using or producing scarce natural resources and industries receiving State aid should normally be subject to State control The form the control may take is illustrated by fixation of prices limitation of dividends prescription of conditions of work and wages for labour, nomination of Government directors on the board of management, etc Where an enterprise is owned by the State there is a *prima facie* case for its management by the State, but whether the State should actually manage it will be decided by considerations of efficient management public welfare and security

In addition to these controls which the State will exercise in future as well during the planning period there will be controls of temporary nature which during this period will have to be resorted to in the fields of production distribution investment foreign trade wages and working conditions Control of production will aim at a proper allocation of resources so as to secure better regional distribution of economic enterprises and to reach the targets set for the different branches of industry It will operate chiefly through a system of licensing new enterprises and extension of old ones Control of industrial distribution will be with a view to determining priorities for the release of raw materials, semi finished materials and capital goods *Control* of consumption in early stages will include rationing and distribution of consumer s goods , later on its object will be to enforce fair selling prices and prevent inflation Control of investment will assume the shape of approval by the State of new capital issues Control of trade and exchange will aim at conserving foreign exchange and protecting Indian industries Control of wages, working conditions will be not merely to ensure fair conditions of labour but also efficiency of management

Results expected The results expected from the Plan at the end of the 15 year period are the following

1 As already noted the *per capita* income will rise from Rs 65 to Rs 135 and the total national dividend from Rs 2 200 crores to Rs 6 600 crores The three fold rise in the national dividend will come about this way The present contribution of industry agriculture and services to the total national dividend is 17, 53 and 22 per cent respectively These percentages

will change to roughly 35, 40 and 20. On their basis there would occur the following increments in the net income from industry, agriculture and services.

		Net income 1931-32 (Rs. crores)	Net income expected after 15 years (Rs. crores)	Percentage increase
Industry	...	374	2,240	500
Agriculture	...	165	2,670	130
Services	...	484	1,450	200

2. The economy of India will still be left mainly agricultural but the present overwhelming predominance of agriculture would be reduced and a more balanced economy established as the occupational distribution given below shows :

Occupational Distribution

		1931 Millions	per cent	1962 Millions	per cent
Agriculture		106.3	72	129.7	58
Industry	...	22.1	15	57.9	26
Services	...	19.2	13	34.7	16
Total working population	...	147.6	100	222.3	100
Total population		338.1	...	494.0	...

3. The average income per occupied person will increase as follows:

		1931 Rs.	1962 Rs.	Increase per cent
Agriculture	...	114	220	93
Industry	...	161	368	129
Services	...	264	397	50

*People's Plan**

Ideology and principles 'People's Plan for the Economic Development of India' which is the full title of this plan is anti capitalistic in its outlook It regards capitalism as being responsible for the economic ills of the country, particulary the poverty of the masses, and holds that any plan of economic development which has the profit motive as its basis cannot benefit the masses It is the socialist's plan It is based on the following principles —1 The profit motive is the enemy of the people 2 The profit motive must, therefore, go or be rigidly controlled 3 Production should be for consumption and not for exchange

Objective The object of this Plan is to provide for the satisfaction of the immediate and the basic needs of the Indian people within a period of ten years These are per adult a well balanced diet yielding 2,600 calories daily, 50 yards of cotton cloth, 100 square feet, at least, of space for decent shelter, freedom from ignorance and freedom from disease At the same time, the Plan makes clear that this objective is not to be understood as indicating a rigid standard which, once attained, would not bother the planning authority any longer, but as the stepping stone to an ever rising standard of living for the people

Cost The objective of the Plan is to be attained by an expenditure of Rs 15,000 crores within the period of planning, distributed as shown under

Rupees (crores)

	Capital	Recurring	Total
Agriculture	2,794	155	2,950
Industry			5,600
Communications	1,420	80	1,500
Health	531 4	227 9	760
Education	573	467	1,040
Housing	3 100	50	3,150
	Grand Total		15,000

*The plan refers to what was British India only The estimates are on the quinquennial level of 1934 39

The expenditure on agriculture will be :

Rupees (crores)

	Capital	Recurring	Total
Reclamation of Land	600	...	600
Irrigation ...	600	15	615
State Farms ...	375	125	500
Soil Conservation and Forest Department	300	15	315
Rural Industries ...	200	...	200
Manures, seeds, etc. ...	720	...	720
Grand Total		...	2,950

The expenditure on industry will be :

Rupees (crores)

Industry		Expenditure
Consumer's Goods Industry	...	3,000
Basic Industry	...	2,600
Total	...	5,600

Ten years' period. In its tempo of development the Plan lays greater emphasis on agricultural production than on industrial and greater on consumer's goods industries than on basic industries. Nearly 66 per cent of the expenditure on agriculture is concentrated in the first quinquennium as against about 20 per cent of that on industries. On this basis the first five years' period may be called the period of agricultural development, while that of the last five years that of industrial development. Agriculture and basic industries are taken up from the first year, the former with an expenditure of Rs. 200 crores, and the latter with one of Rs. 100 crores. Expenditure on consumer's goods industries, health and education starts in the second year, that on communications in the fourth year and that on housing in the fifth year. Cottage industries are

relegated to the background

The argument is this Agriculture is the principal industry of India About 70 per cent of the people are employed in it and they are in a poor way They lack purchasing power That stands in the way of the development of large-scale industries Agriculture must, therefore, form the foundation of any attempt to plan the economic life of the country Agricultural development is, therefore, given the first priority It will bring about an increase in the output of agriculture and thereby in the income of the cultivator That will be sufficient not only to meet the needs of the population but also leave surplus to be absorbed in the economy of the country The increased income in the rural areas will lead to an expansion of the internal market so as to enable it to absorb an increasing volume of consumer's goods A proper basis for the development of industries will consequently be provided and the development of the consumer's goods industries will become urgent But as the growth of industries and the provision of such services as health, education, etc will depend upon the extent to which a surplus is created on land, they are to begin in the second year As to the basic industries, they begin from the beginning but on a smaller scale, because an adequate development of the consumer's goods industries or the increase contemplated in agricultural production is inconceivable without their development and also because in their absence the foundation of a proper industrial development in the country must remain weak, but it is a little pathetic, and may even prove to be considerably harmful, to see people making a start with half fitted bellies and half clad bodies, thinking in terms of automobiles and aeroplanes The development of communications and housing comes later because the farmer is, consequent on agriculture and industry, producing goods enough for circulation in the internal market and yielding a sufficient surplus for investment in communications and the latter upon the surplus becoming available for construction of houses

Method The methods proposed in the Plan for achieving the object in view are anti capitalistic or socialistic in character In agriculture, the Plan advocates the nationalisation of land and underground riches—mines, with compensation and compulsory liquidation of the rural debt The compensation in the case of the latter is to take the form of 40 years self-liquidating bonds carrying a 3 per cent rate of interest These two measures are to be supplemented by an extension of the

area under cultivation as well as the intensification of cultivation of the area already being cultivated. The former can be done by bringing the 'culturable waste' under the plough ; the Plan aims at bringing 100 million acres out of the 170 million acres of such land under the plough in the ten years' planning period. The latter can be achieved by an extension of irrigation (the target here is 400 per cent increase in the area irrigated at present), the provision of manures and improved seeds, increase in the scale of cultivation from the tiny fragments of the present to huge collectives, schemes of soil conservation like anti-erosion measures, afforestation schemes, etc., and the association of machinery with the process of agricultural production. The intensification of cultivation and the association are to be facilitated by the starting of State farms all over the country. The number of such farms needed will be about 25,000. These will hasten the process of collectivisation and training up of a cadre of efficient and scientific rural workers from among the cultivators. Collectivisation is to be voluntary and the Government should promote it in three stages. The first stage will be in the case of the new land to be brought under the plough, which can be done only as a result of a 'collective attack'. The next stage will be the State farms using modern machinery which will serve as examples for the peasantry of the benefits of collective cultivation. And the third stage will pertain to the land cultivated today as small unremunerative strips in the cultivation of which modern machinery under such conditions cannot be used. The increase of agricultural production envisaged is 400 per cent or more.

The policy in regard to industry will be one of ownership in some cases and of rigid control in others. All the new industries to be started during the period of the Plan will be financed by the State. Industries financed from the public funds will naturally be owned and controlled by the State. This will be side by side with rigid control over the existing industries in which private capital has already been invested. The full expropriation of private interest in industries is not suggested. What is proposed is control in their case over the profit motive. The full and uncontrolled operations of the profit motive may lead to the stupid result of killing the goose that lays the golden egg. The revenue permitted and guaranteed to private capital in these industries is fixed up at 3 per cent as maximum. Industrial production is visualised to increase 600 per cent.

As to trade, the attitude towards it is again of strict regulation. The circulation of commodities is not to be left to the normal channels of trade which are known to behave in the most abnormal and anti social manner and cause artificial scarcities. The Plan suggests that the circulation of commodities between the town and the village should be organised through Producers' and Consumers Cooperatives. The collective farms can function as the whole sale cooperatives in the rural areas while the State-owned and controlled industrial plants can do so in the urban areas. Under these there should be organised a net work of cooperatives all over the country which will take up the work of distribution of comodities at prices fixed by the State within the limit of the purchasing power of the consumers. Pending the creation of such a country-wide machinery, the present channels of trade are to be allowed to function subject to a maximum revenue of 3 per cent. Of course, the State will have to exercise effective control over the banking and other financial institutions in the country and take up a monopolistic position in respect of foreign trade as well as all financial transactions with foreign countries.

The reform and reorganization of agriculture, of industry and of trade together with the development of the health, education and housing services and the extension of communications will provide employment for vast numbers, leaving the remaining unemployed if any to be absorbed in the private sector of industry and bring about an increase in their incomes. Thus an equitable distribution of wealth will take place. The rise in the standard of living will be great especially when it is borne in mind that under the Plan all the services in respect of health, education and housing are to be rendered free to the population concerned.

Finances. The proposals for financing the Plan are the following:

Sources	Rupees in crores
Sterling Balances	450
Initial Finance-estate duty, inheritance tax, death duties etc	810
Income from Nationalised Land in the pre first year of the Plan	90
Income from Agriculture for—reinvestment	10 816
Income from Industries for reinvestment	2 834
Total	15,000

The Plan visualises a capital expenditure of Rs. 1,600 crores for the first three years. This is to be met mainly out of the sterling balances and taxation. With this investment into the economy, the Plan can be expected to finance itself. The total agricultural income during the period of the Plan is estimated at Rs. 31,300 crores, and after payment to landlords and money lenders it comes to Rs. 30,700 crores. Out of this sum, about 60 per cent amounting to Rs. 18,784 crores is left for current consumption and Rs. 1,100 crores for investment in the eleventh year, so that the amount which will be available as investible surplus during the planning period will be Rs. 10,816 crores. In the same way the net industrial income after meeting the charge of private capital is Rs. 9,223 crores of which about 54 per cent amounting to Rs. 5,074 crores is left for consumption and Rs. 1,315 crores for investment in the eleventh year. Thus, the net investible surplus from industries for the purpose of developing the economy comes to Rs. 2,834 crores.

Results expected. The Plan estimates an increase of 400 per cent in agricultural production and of 600 per cent in industrial production. No increase is visualised so far as the services are concerned. On the basis of the income available for consumption from agriculture the rural per capita income will rise from Rs. 29 per year during the first year to Rs. 121 during the last year. The rise for the urban population for the corresponding stages will be from Rs. 57 to Rs. 172 per year. This means an improvement by over 300 per cent for the rural population and by 200 per cent for the urban. The average per capita income from these two sources comes to Rs. 33 per year during the first year and to about Rs. 128 per year for the tenth year. This means that the common man of India will live four times better as a result of the execution of the Plan.

*The Gandhian Plan.**

Ideology and Principles. Mahatma Gandhi did not formulate a definite plan for the economic development of India. But he stated off and on, his views on the various facts of economic activity of the country and laid down a constructive programme of the *charkha*, the village uplift and basic education. On the basis of his economic views and the constructive programme one of his devoted disciples, Principal Shriman Narayan Agarwal of Wardha College of Commerce, has placed before

* All the estimates are pre-war estimates.

the public a coordinated and comprehensive scheme of a planned economy of India, which for all intents and purposes, represents the type of planned economy the Mahatma would have liked to see established in India The scheme is published in a brochure entitled 'The Gandhian Plan"

Mahatma Gandhi's approach to the economic problem represents a revolt against modern industrialism—its concentration and mechanisation of industries, its exploitation of labourers and peoples, its pride and pomp, its jerks and jolts, its idolization of money and material comforts and its neglect of the higher destination of mankind He would have none of all this To him life was not simply labour and wages, production of material goods and services and consumption thereof It connoted moral and cultural values His ideal was a simple, contented and cultured life in which the extremes of poverty and riches were absent He wanted every one to have a certain standard of competence earned with the sweat of one's brow and also a certain sense of freedom which would make possible the attainment of one's personality Such a life is enjoyable in a decentralised economy such as that of self-sufficient village communities and cottage industrialism which existed in India of the past

The Gandhian approach to a planned economy is thus a moral and cultural approach It is underlaid by idealistic philosophy It aims at a harmonious combination of material, moral and cultural well being of the people Its principles are four 1 *Simplicity* 2 *Non Violence* 3 *Dignity and Sanctity of Labour* 4 *Human Values* *

1 *Simplicity* Centralisation, mechanisation, multiplication of wants and hunt for money which characterise present day economic activity imply complexity of life and unhappiness, restlessness and discontentment in consequence The more an individual has the more he wants to have He runs after material comforts and luxuries and becomes a slave of his passions Money which is meant to be a means of exchange becomes an end to be pursued ruthlessly But money and material goods are not wealth The real wealth of a nation consists in her honest, cultured and unselfish men and women and not in her palatial buildings, huge factories and multifarious luxuries Progress should not be identified with complexity A progressive economic system should lead to greater simplicity, though fuller life The purpose of all human activity is the development and unfoldment of human personality in an at

* All the estimates are pre war estimates

mosphere of freedom. This purpose can be achieved only through plain living and high thinking. Such a living is possible in a simple, decentralised economy of self-sufficient villages and cottage industries.

2. *Non-violence.* Mahatma Gandhi was an apostle of non-violence. He would have nothing to do with violence in any shape or form. Violence cannot lead to lasting peace and socio-economic reconstruction. True democracy and development of human personality can only come in an atmosphere of non-violence. Capitalism is based on the exploitation of labourers. Machinery which goes with it displaces labour and pours wealth into the pockets of a few. This wealth is accumulated through violence and what is obtained through violence is attempted to be maintained by violence. The Mahatma, therefore, did not favour capitalism and its hand-maid gigantic machines. "Machinery" he said "represents a great sin". Nor would he have any truck with Fascism or Communism. These do not scruple to use violent means to attain their ends. With him ends did not justify the means. The ends should be pure and the means to attain the ends should be equally pure. He would not even expropriate the capitalists and the landlords. Their expropriations would be violence. Rather than be expropriated they should be reformed through proper persuasion to regard themselves as trustees of their property for public welfare. An atmosphere of non-violence which would lead to the results Mahatma Gandhi had in view—*true democracy and unfoldment of personality* can, according to him, obtain in an economic organisation the basis of which is self sufficient villages and small scale industries carried on with manual labour mainly and with machinery only to the extent to which machinery lightens the burden of the handicraftsmen.

3. *Dignity and Sanctity of Labour.* Mahatma Gandhi regarded work as worship. Manu said: "The hand of an artisan is always pure". Mahatma Gandhi would have said: "The hand as well as the mind of an artisan are always pure". To labour is the law of nature. The violation of this law is the cause of many an ill. An idle man's brain is devil's workshop. He who does not labour leads the life of a thief. He lives by robbing others. He is committing violence. Men should work and keep their minds engaged. They should take pleasure and pride in their work. There should be *production by masses* and not *mass production.* The cry for leisure is raised by those who work in factories and whose work is soulless, monotonous and strenuous. Those who

work with their hands do not clamour for leisure. Their work gives them joy. The ideal distribution of time, according to Mahatma Gandhi, is eight hours' work, eight hours' sleep and eight hours' leisure for social and cultural pursuits.

4 *Human Values.* Modern civilization lays much too much emphasis on money values and material wealth. To it riches are every thing and men absolutely nothing. It makes the dead bodies of thousands as stepping stones to rise to more and ever more riches. Its concern is high dividends. Men might go to the wall for aught it cares. Mahatma Gandhi would not stand such a state of affairs. He stressed moral and human values. He did not draw a sharp or any distinction between Economics and ethics. Economics that hurts the moral well-being of an individual or a nation was to him immoral and therefore sinful. He condemned as sinful to buy and use articles made by sweated labour, to go to the cheapest market while producers in the neighbourhood starved for lack of customers. "The value of an industry" he wrote "should be gauged less by the dividends it pays to sleeping shareholders' than by its effects on the bodies and souls of the people employed in it". With him man came first : he is the end; and riches came afterwards; they are simply the means to that end. "Man" he said "is the supreme consideration", and "life is more than money".

Objective. The objective of the Gandhian Plan is to raise the material as well as the cultural level of the Indian masses to a basic standard of life within a period of 10 years. A basic standard of material and cultural well-being implies the availability of all the basic necessaries of life together with the minimum comforts. They are (i) balanced and health-giving food, (ii) sufficient clothing (20 yards per head per annum in rural areas) against inclement weather, (iii) housing accommodation of 100 square feet per head, (iv) free and compulsory basic education, (v) medical facilities through fairly well equipped dispensaries or hospitals and maternity clinics for women, (vi) public utility services for all, like postal, banking and insurance facilities, and (vii) recreational facilities through folk dances, indigenous theatres, *bhajan and mandalis, etc.*

To enable the masses to enjoy this basic standard of life the income that will be needed is estimated to be at least Rs. 72/- per head per annum The present average annual income in rural areas is only Rs 18/-. So it will be necessary to quadruple the per capita income of at least 90 per cent of the Indian people.

Cost. For the purpose of quadrupling the per capita per annum income of the Indian masses, the Plan estimates that a total investment of Rs. 3,700 crores will be needed, allocated among the different items as follows :—

Rupees (crores)

Item	Non-recurring	Recurring
Agriculture	1,175	40
Rural Industries	350	—
Large scale and Key Industries	1,000	—
Transport	400	15
Public Health	260	45
Education	295	100
Research	20	—
Total	3,500	200

This distribution of expenditure may be explained a little. About 90 per cent of the Indian people draw their subsistence from agriculture and allied industries and they are miserably poor and awfully ignorant. The plan, therefore, attaches the main importance to their welfare. It proposes an expenditure of Rs. 1,525 crores on the development of agriculture and subsidiary rural industries. But as in a country like India, there must be established a few basic industries particularly because they will not hinder but help the growth and evolution of small-scale industries. A sum of Rs. 1,000 crores is alloted to this item. Also as other departments of national life have their importance, they are not left out of account but are paid the attention that is considered proper.

Methods. The Plan attempts to achieve its objective of quadrupling the average per annum income of the Indian masses on a foundation of self-governing and self-sufficient village communities or *Gram Panchayats* characterised by plain living and high thinking. These *Panchayats* will be autonomous in regard to their internal administration and self-sufficient in regard to at least the basis necessaries of life like food, clothing and building materials. Their functions will be allotment and collection of land revenue on behalf of the village, maintenance of peace and order in the village, administration of justice in

local disputes, organisation of basic and adult education, provision of medical aid, sanitation and maintenance of buildings, roads, tanks, wells, etc., improvement of agriculture of the village by cooperative effort, regulation of village trade, industry and commerce, and arrangement of cooperative purchase of raw materials and consumption goods and the cooperative sale of farm produce and articles of village handicrafts.

In agriculture, the problem of raising the productivity of land and the income of the ryot is to be solved by radical reforms, such as nationalisation of land and a system of village land tenures. The land may be nationalised with reasonable compensation to the title-holders or by levying heavy inheritance taxes or death duties. Then, in place of the *zamindari* or *ryotwari* system, the *mauzawari* settlement or village land tenure system is to be introduced. Land will be given on long leases by the State to those who *actually* till it. Simultaneously, the evils of fragmentation are to be removed by consolidation of holdings on a voluntary basis, cooperative farming of adjoining plots, modification of the existing system of inheritance and exemption of uneconomic holdings from payment of revenue. Other steps will be the liquidation of rural indebtedness by issuing 20 year's State bonds to the money lenders and asking ryots to pay their debts in 20 annual instalments, reclamation of 'culturable waste' and prevention of soil erosion, extension of irrigation facilities, use of cattle manure and artificial fertilizers, improvement of cattle, employment of better implements and better seeds, introduction of agricultural insurance and above all cooperative effort in every direction, e.g. cooperative farming, cooperative marketing and cooperative credit.

In addition to these measures there will be development of industries allied to agriculture such as dairy farming, tanning and leather work, fruit culture, vegetable gardening, forest industries, etc.

The objective of the Gandhian Plan being the attainment of maximum self-sufficiency in the village economy at least with regard to the consumer's goods, the cottage industries that will cater to the needs of the villagers in this respect are to be paid proper attention. These industries are *Khadi*, paper making, oil extraction, paddy-husking and others like gur-making, bee keeping, flour grinding, poultry farming, carpentry, smithy, brick making, etc. They will be developed in accordance with local conditions and needs.

In regard to the development of industries neither the traditional capitalist method nor the traditional socialist method

is to be applied. The former is discounted because it leads to large cities, palatial buildings and dirty slums and a concentration of power and wealth in the hands of a few. It means opulence on one extreme and poverty on the other. It converts a vast number of people into automatons and makes culture the monopoly of the privileged classes. The latter is repudiated because it will make for the growth of large cities throughout India and an increasing differentiation between cities and villages which leads to acute sociological problems. It will also concentrate too much power in the hands of the State bureaucracy, and thus curb the initiative of the people and reduce democracy to a *farce*. Then, both the traditional methods involve heavy mechanisation which means dull monotony for the workers and reduction of their work to a ceaseless repetition of mechanical movments. Mechanisation may imply efficiency but it results in cultural bankruptcy. Under it people produce large battleships but little culture. India should not follow the road to cultural bankruptcy. Full scope must be given to human personality.

The method to be employed in respect of industrial development is the "modified socialist method". The key or basic industries such as defence industries, power, mining, metallurgy and forestry, machinery and machine tools, heavy engineering, chemicals, and public utility services like transport and communications being meant to be beneficial to the whole country, are to be owned and managed by the State in the interests of the nation as a whole. Only those industries that for technical reasons, cannot be organised on the basis of small units, are to be allowed to develop on a large scale. The test here will be not efficiency, but technical needs. The existing private large-scale and key industries are ultimately to be acquired or purchased by the State. In the meantime they are to be put under rigid control and supervision of the State with regard to the prices of goods, profits, conditions of labour and competition with cottage industries. The large scale private consumer's goods industries like textile, oil, sugar, paper and rice mills, are to be permitted to continue if they fall in line with the strict discipline and control of the State. They are not to compete with the corresponding cottage industries and shall exist only so long as the village industries are not able to produce the required quantities of those consumers' goods. The proper place of large-scale and key industries is for the exploitation of the national resources on a service basis for the benefit of the producers working cottage industries scattered all over the villages. That is, they are to

serve as accessory to the village and cottage industries and the cottage industries are not to be subsidiary to them.

As to rural and cottage industries, their revivification is to be the chief plank of the State in its industrial and planning programme They will solve the crucial problem of unemployment of 50 per cent of the people and supply all the consumers' goods to the people. They will also afford adequate scope for private or cooperative enterprise and *initiative*. *Also*, though *not* State-owned, they will not provide much room for the 'vested interests' and there will, therefore, be scarcely any chance for Indian or foreign capitalists to exploit India for their own selfish interests. The State is expected to encourage and help their development in every way—by providing cheap credit facilities through cooperative credit societies, imparting suitable technical education in basic schools and adult classes, making available scientific knowledge to modernise them, arranging for the collective purchase of the raw material needed from outside the villages, assisting the cooperative marketing of their surplus goods, protecting from the competition of large-scale industries, granting subsidies by taxing large scale industries, if necessary, bringing electric power to the villages and so on. These industries will be run on a cooperative basis under the control and direction of the village *Panchayats*.

With regard to trade and transport, these are also to subserve the interests of the self-sufficient, decentralised economic units. The organisation of these units will reduce the need for trade to the minimum and lower the pressure on the national transport to a considerable extent. Still, there will take place some trade between different economic units on the basis of mutual benefit. They will export those goods of which they have a distinct surplus or which can be produced or grown only in them and import those commodities which they cannot produce but must have as necessaries of life. Consequently, it will be necessary to extend the means of transport in some parts of the country to facilitate the necessary trade. But both trade and transport are to be so conducted and developed as to benefit the masses and not to suit the convenience of any capitalist. The trade should take place to provide for local consumption of the greatest possible portion of the total produce, and the means to transport are to be extended to help and not to hinder the cottage industries by making possible the supply of cheap raw materials and facilities for the sale of the surplus produce Railway rates are to be so scheduled as to promote the same end. Trade will be carried on by the cooperative organisation in the village or regional

units. Private individuals may be permitted to carry it on only under the control of the State in regard to prices, margin of profit and extent of the market.

Some other measures are control of the international trade of the country by the National Government with the object of attaining maximum national self-sufficiency, training the youngmen in educational-institution in the arts and crafts of the cottage industries in accordance with the Wardha Scheme of Education, moderating the evil effects of money economy by a judicious use of barter and payment in kind, etc.

Finance. The non-recurring cost of Rs 3,500 crores of executing the Plan is to be met from the following sources :—

	Rupees (crores)
Internal borrowing	2,000
Created money	1,000
Taxation	500
Total	5,300

The recurring expenditure of Rs. 200 crores will come from State-owned basic industries and public utility services like transport, communications and irrigation.

Results expected. The Plan if and when executed is expected to effect a wonderful transformation in the economy of India. The lot of the masses will improve considerably. The exploiters and oppressors like rentiers, capitalists and users will disappear or become harmless in consequence of the nationalisation of land and introduction of village land tenures, the liquidation of indebtedness, the decentralisation of production in small self-sufficient economic units and the owning by the State of basic industries and public utility services. The problem of unemployment will be solved since so many cottage industries will come into existence. The problem of distribution will be greatly simplified as production and consumption will be localised or regionalised. The exploitation by the merchant, middle man will go because trade will be controlled in the interests of the masses. Altogether, the Plan will usher in an era of peace and prosperity in the land based on plain living and high thinking.

Critical Estimate

None of the three Plans that have been explained is perfect No plan can be perfect till man becomes perfect The three Plans represent three different ideologies Each from the point of view of its ideological approach is satisfactory enough But each when examined from all points of view, has certain defects The merits and demerits of each may be noted

I *The Bombay Plan Merits* This Plan carries the plan for setting the pace for economic planning in India It is the pioneer systematic work of its kind It is brief, lucid and drives straight to the object in view It has a clear-cut aim It has formed the basis of further discussion on the subject It has made the entire nation planning minded All this stands to its credit

Demerits On the debit side of the Plan might be put down the following —1 The plan would preserve the capitalist order which has been tried and found wanting It would allow a compromise between State and private enterprise but would regard planning as a form of temporary State control The controls suggested under production, distribution, consumption, investment, trade and wages are all to be "controls of a temporary character' They are also hedged in so as to keep the interests of big business safeguarded For example, wages, interest and profits are to be controlled by the State and at the same time they are to be permitted to be determined by *demand and efficiency*, subject to the condition that wages are not to fall below a certain minimum, interest rates are to be controlled in order to maintain full employment and profits are to be controlled through fixation of prices, restriction of dividends and taxation, but *sufficient incentive* is to be allowed for expansion of production No doubt, these controls will help ease the economic situation to a certain extent, but they cannot remove the malady The root cause of the trouble is the profit motive So long as it does not go or is not rigidly controlled the trouble cannot disappear Chronic unemployment, periodic crises and sharp inequalities will continue

2 The Plan is primarily a plan for production Distribution is an after thought. Production should certainly precede distribution But production is for consumption and consumption can take place only if the consumers have purchasing power In the absence of purchasing power on the part of the Indian masses, mass production contemplated under the Plan cannot fulfil its purpose of being consumed It can do so if

purchasing power is equitably distributed. The Plan does not suggest effective steps for doing this. Minimum wage rates, multipurpose cooperatives, ryotwari land tenures etc., which are proposed will not go a long way to bring enough money into the pockets of the country's masses.

3. The Plan is very much biased in favour of industrial development as compared with agricultural. It allots about four times as much money for the former as for the latter. It visualises a 500 per cent increase in the industrial output as against 130 per cent increase in agricultural production. This is because "the industrial potentialities of the country have remained unexplored thus far". But it forgets that the possibilities of agricultural development of the land are equally great and unexploited. It also forgets its own admission of the fact that agriculture will remain a predominant occupation for a long time to come and must be as much developed as manufactures. Further, it forgets that even for expanding manufactures agriculture will have to be developed as it will supply raw materials. The bias in favour of industries is equally to be seen from the viewpoint of distribution. The increase in agricultural income is calculated at 90 per cent as contrasted with 129 per cent increase in industrial income. The reaction of this on the economy of the country is lost sight of. It will be to keep the submerged agricultural masses poor rather than prosperous as compared with industrial employees.

Even the measures, called "fundamental reforms", suggested for increase of agricultural production are nothing more than consolidation of holdings, cooperative farming, conciliation and liquidation of debts through cooperative societies, afforestation, irrigation, extension and intensification of cultivation, cannot be of much avail to penniless cultivators. The expenditure of Rs. 1,240 crores alone will fail to achieve the miracle of plenty in the atmosphere of penury. The money lenders will not be converted from their vocation of usury into simple-minded depositors for financing the very men whom they ruined at one time.

4. The sources from which the Plan is to be financed are not sound. They are open to objection either because they will lead to undesirable consequences or because they are not altogether dependable. The major sources are savings, Rs. 4,000 crores and 'created money' Rs. 3,400 crores. The former, to the extent to which available, will mean investment by the rich mainly. This is to say that the ultimate creditors of the nation

will be the capitalists. Their pockets will bulge out resulting in accentuation of inequalities. The latter is a dangerous device as it is likely to lead to inflation and consequential sufferings of the middle and the poor class people. Foreign borrowing, Rs 700 crores will bring troublesome elements into the economy unless it is properly controlled. Sterling securities, Rs. 1000 crores, balance of trade, Rs. 600 crores, and hoarded wealth, Rs. 300 crores cannot be relied upon, at any rate, to the full extent. Taxation. which is the only equitable source is not included in the list of sources at all. Then the classification of the sources is defective. Hoarded wealth is put under external finance. Why, none can say? It is as much internal capital as 'savings'. Similarly 'balance of trade' being due to excess of exports is as much the income and saving of the nation as any other income or saving

5. The estimates involved in the Plan, based as they are on the income-estimate of 1931-32 and the price level of the thirtees do not give a realistic picture of the thing or any reliable results. Those prices have long been left behind and are not likely to return. No doubt, a certain stable standard is needed to start with, but the thirtees do not supply it. The Plan was contemplated to start in 1946-47. 1944. or 1945 figures would have been better to start with. This, however, is a defect which the Plan shares with the other two Plans. The estimates of these two plans also have as their basis the pre-war price level.

II. *People's Plan. Merits* This Plan has not received the publicity that it deserves. Rigid censorship of it by the capitalist-controlled press has been the cause of this fact. The Plan has a number of good points. They are :—

1. It is right in holding capitalism responsible for the poverty of the masses and just in pleading for production for use as against production for exchange or to meet effective demand.
2 It shows a proper appreciation of the real state of affairs as it emphasises the development of agriculture and of consumers' goods industries instead of that of the heavy industries. It says: "It is an indisputable fact that the main difficulty in the way of development of large-scale industries in India has been the all-too-meagre purchasing power in the hands of a large majority of the people". "Any attempt to increase the purchasing power of the people will have largely to concentrate on agriculture which affords the main channel of employment to a majority of the people". "The industries on the development of which there should be laid a greater emphasis by the planning authorities should be the consumers' goods" for " it is indeed a little

pathetic and may indeed prove to be considerably harmful to start with half-filled bellies and half-clad bodies, thinking in terms of automobiles and aeroplanes". 3. Its methods suggesting nationalisation of land, compulsory liquidation of debt and rigid control of the profit motive in industry and trade are salutary.

Demerits. The bad points of the Plan are the following : –

1. Of the total expenditure of Rs. 15,000 crores it makes provision for only Rs. 1,600 crores. The balance amounting to more than 90 per cent of the total is to be met from the supposed surplus of the agricultural production after three years and from the self-financing capacity of its measures. This is Utopian and fantastic.

2. The Plan, in spite of its socialistic outlook and policy, does not go the whole way. It does not suggest the nationalisation of banks and credit which is very essential in a controlled economy.

3. The Plan proposes voluntary collectivisation of land through the instrumentality of State farms. Voluntary collectivisation can come about provided the rural masses have sufficient education, understanding and consciousness under the existing circumstances; they are illiterate and undeveloped. So the method cannot be expected to achieve much. Compulsory collectivisation alone can effect the reform.

4. Some other points on the score of which the Plan is regarded as defective are : (a) it accords practically no place to cottage industries in the proposed economy, (b) it regards 3 per cent profit guaranteed by the State as enough to maintain industrial efficiency and (c) it wants abolition of landlordism and usury with compensation and not also the liquidation of private industry which is equally parasitic These objections are raised from different angles of vision and whether they are justified or not will depend upon the viewpoint from which one looks at them. The authors have explained their stand in the brochure.

III. *The Gandhian Plan. Merits.* This Plan is characterised by simplicity and high degree of relevance to actual facts. Its merits are : 1. It lays proper emphasis on the development of agriculture and improvement of village economy. About 90 per cent of the people live in villages uncared for and immersed in poverty. The villages constitute real India and not a few cities with their big factories and high buidings. A scheme of economic reconstruction of India must. therefore, aim at the prosperity of the villages

2 It draws attention to the desirability of the decentralisation of industries The concentration of industries in big cities and suburbs has produced evil results To check the evil the Plan rightly proposes that new concerns should be spread out in rural areas as far as practicable within the limits set by the accessibility of raw materials and motive power", as has been done in U S S R with wholesome effects

3 The importance the Plan attaches to human values as opposed to material riches is very creditable Modern industrialism neglects the former and stresses the latter This is wholly wrong Man is the ultimate end of all activity He is everything and riches nothing in comparison Only as much riches are worth having as will enable him to attain the development of his personality Plain living and high thinking is an excellent ideal

Demerits The Gandhian Plan suffers from the following defects —1 Its ideal of village self sufficiency cannot command much force in the modern context The development of cottage industries and the reversion to barter that the Plan suggests for reaching the ideal will mean putting back the hands of the clock of progress The economies of large scale production are decidedly superior to those of small scale enterprise The industries that can be run on a cottage basis are those only in which machinery cannot be much used—like carpet making To attempt to revive local self sufficiency will be uneconomic The bringing in of barter will equally take the country backwards The U S S R tried it in the beginning of the Revolution but had to give it up because of the economic chaos it led to 2 It points out the need for equality of distribution but does not suggest any effective measures for bringing it about in actual practice The steps proposed are more or less the same as enumerated in the Bombay Plan 3 It decries complete socialisation because it fears the dictatorship of the bureaucracy But it does not say how the nationalisation of the basic and key industries will escape the same dictatorship Then its faith that the propertied individuals can be so reformed that they will regard their property as a trust to be administered for public welfare cannot cut much ice

Summary To sum up he Bombay Plan is a Plan for industrial development, the People s Plan is a Plan for agricultural development and the Gandhian Plan a Plan for rural development That is to say the three Plans lay chief stress on the development of one sector of the Indian economy only But it is clear that any Plan that has as its aim the welfare of the country

as a whole cannot be successful if it confines attention to one aspect of the economy only. All departments of the economy must be developed simultaneously. Of course, the rural part must be tackled first, alike because the majority of the people derive their subsistence from agriculture and industries are subsidiary to it and because it is a department that can be developed much more quickly and easily than industries. It has, however, to be borne in mind that the development of each department of the economy will help the development of other sections, nay it cannot be carried very far unless the other sections are developed side by side with it.